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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED

ECONOMIC GROWTH AND FISCALLY SUSTAINABLE SERVICES
POLICY BASED GUARANTEE

IN THE AMOUNT OF
US\$ 750 MILLION EQUIVALENT

TO

UKRAINE

NOVEMBER 16, 2018

Macroeconomics & Fiscal Management Global Practice (GMFDR)
Belarus, Moldova, and Ukraine Country Unit (ECCEE)
Europe and Central Asia (ECA)

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UKRAINE – GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of November 16, 2018)

Currency Unit	UAH
US\$1.00	UAH 27.95

Weights and Measures
Metric System

ABBREVIATION AND ACRONYMS

CPF	Country Partnership Framework	MOF	Ministry of Finance
DB	Doing Business	NABU	National Anticorruption Bureau of Ukraine
DH	District Heating	NACP	National Anticorruption Prevention Agency
DPL	Development Policy Loan	NBU	National Bank of Ukraine
DTF	Distance-to-frontier	NPL	Non-performing loans
EBRD	European Bank for Reconstruction and Development	OECD	Organization for Economic Cooperation and Development
ECA	Europe and Central Asia	PDO	Program Development Objective
EFF	Extended Fund Facility	PEFA	Public Expenditure and Financial Accountability
EIB	European Investment Bank	PIM	Public Investment Management
EU	European Union	PIMA	Public Investment Management Assessment
FY	Fiscal Year	SBA	Standby-Arrangement
GDP	Gross Domestic Product	SFS	State Fiscal Service
HUS	Housing and Utility Subsidy	SLB	State Land Bank
IAC	Inter-Agency Committee	TA	Technical Assistance
ICR	Implementation Completion and Results	UAH	Ukraine Hryvnia
IMF	International Monetary Fund	UN	United Nations
JICA	Japan International Cooperation Agency	USD	United States Dollars
M&E	Monitoring & Evaluation	VAT	Value-added Tax

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UKRAINE

ECONOMIC GROWTH AND FISCALLY SUSTAINABLE SERVICES POLICY BASED GUARANTEE

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SUMMARY OF PROPOSED GUARANTEE AND PROGRAM
UKRAINE
ECONOMIC GROWTH AND FISCALLY SUSTAINABLE SERVICES
POLICY BASED GUARANTEE

Borrower	Ukraine
Implementing Agency	Ministry of Finance (MoF)
Financing Data	IBRD Policy Based Guarantee Amount: Guarantee of US\$ 750 million equivalent Terms: Maturity of 10 years
Operation Type	Policy Based Guarantee, not programmatic, single tranche
Pillars of Operation and Program Development Objective(s)	The proposed program development objectives are to: (i) <i>Strengthen factor markets and institutions; and</i> (ii) <i>Promote fiscally sustainable and effective services</i>
Results Indicators	<ul style="list-style-type: none"> • Number of State-Owned Bank supervisory boards with at least two-thirds of independent board members increases from 1 in 2016 to 4 in 2019. • Amount of registered state land increases from 1 million hectares in 2016 to 4 million hectares in 2019. • Number of cases under review by the High Anti-Corruption Court increases from 0 in 2016 to 25 in 2019. • Average old age pension replacement rate increases from 27 percent in 2016 to 30 percent in 2019 and pension expenditures remain stable at under 11 percent of GDP in 2016 and 2019. • Share of HUS going to bottom 40 percent of the population increases from 46 percent in 2016 to 50 percent in 2019. • Energy Efficiency Fund (EEF) becomes operational and initiates the provision of resources for building retrofits in 2019. • Share of health spending on primary health care increases from 12 percent in 2016 to 15 percent by 2019. • Share of adult men receiving CVD drugs reimbursed by the government increases from 0 percent in 2016 to 4 percent in 2019.
Overall risk rating	High
Climate and disaster risks	Are there short / long term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)? No If yes, (ii) summarize briefly these risks in the risk section and what resilience measures may help address them?
Operation ID	P164414

**IBRD PROGRAM DOCUMENT FOR A PROPOSED
ECONOMIC GROWTH AND FISCALLY SUSTAINABLE SERVICES
POLICY BASED GUARANTEE
TO UKRAINE**

I. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed Policy Based Guarantee (PBG) supports Ukraine’s efforts to address critical structural bottlenecks and governance weaknesses in a challenging economic environment.** Ukraine undertook far-reaching reforms in the face of unprecedented shocks in 2014-2015, which helped stabilize the economy and the financial sector, reduce large macroeconomic imbalances, and cushion the impact of the shocks on the population.¹ As a result, after a cumulative 16 percent contraction in 2014-2015, the economy grew by 2.3 percent in 2016 and 2.5 percent in 2017, and the fiscal deficit was reduced from 10 percent of GDP in 2014 to 2.3 percent of GDP in 2015-2017. At the same time, the recovery of growth has been weak, macroeconomic vulnerabilities are considerable (with public debt at 71.9 percent in 2017 and major fiscal financing needs in 2019-2020), and poverty remains significantly elevated compared to pre-crisis levels (estimated at 24.5 percent in 2016, up from 14.1 percent in 2014). Deep structural bottlenecks and governance challenges have contributed to the weak growth recovery, unsustainable fiscal spending, and ineffective social services. In addition, Ukraine faces headwinds from the ongoing conflict in the Donbas region, Presidential and Parliamentary elections scheduled in 2019, and considerable challenges in advancing reforms in a complex political environment.²

2. **The proposed operation supports reforms to tackle the structural underpinnings of Ukraine’s weak growth recovery and ongoing fiscal vulnerabilities under two key pillars: (i) strengthening factor markets and institutions; and (ii) promoting fiscally sustainable and effective services.** First, weaknesses in factor markets and high levels of corruption impede investor confidence and productivity along multiple dimensions: (i) a large and politically exposed state-owned banking (SOB) sector and high share of non-performing loans constrain efficient financial intermediation and credit growth to the private sector; (ii) a longstanding moratorium on the sale of agricultural land undermines incentives to invest and tap Ukraine’s tremendous potential in agriculture; and (iii) while asset declarations and investigations conducted by Ukraine’s new anticorruption institutions have increased transparency, an independent anticorruption court to credibly adjudicate cases is needed to improve corruption perceptions and accountability. Second, social benefits and services in Ukraine, including pensions, energy subsidies, and health care are fiscally costly and ineffective. This increases macroeconomic vulnerabilities. It also adds to the reliance of household incomes on unsustainable social benefits, while impeding job creation and the shift toward a greater reliance on wage income.³ The PBG-supported reforms were selected based on their criticality for achieving the development objectives under each pillar; government priority to complete the reforms; and the World Bank’s comparative advantage in contributing to the design and implementation of the reforms.

3. **With corruption and vested interests deeply entrenched in Ukraine, the proposed operation pursues a two-pronged strategy of strengthening cross-cutting anticorruption institutions and**

¹ These reforms were supported by the World Bank (through two series of DPLs amounting to \$2.25 billion) in coordination with the IMF and other development partners.

² Ukraine has experienced acute political and security challenges during the last four years. Following the Euromaidan uprising in November 2013, developments in Crimea in March 2014 led to the UN General Assembly resolution 68/262 affirming the territorial integrity of Ukraine. A military conflict with armed groups in the Donbas region of eastern Ukraine broke out in April 2014 and remains unresolved, with over 10,000 killed and over 2.7 million displaced.

³ See Ukraine Systematic Country Diagnostic, *Toward Sustainable Recovery and Shared Prosperity*, 2017.

advancing reforms to disempower vested interests in key sectors. Beyond the specific prior action on strengthening anticorruption institutions, the prior actions on land, the financial sector, energy subsidies, and health care also address major sources of corruption and weak governance in these sectors. Ukraine has struggled with corruption and state capture since its independence. Nontransparent privatization of state assets in the early years of transition, state-regulated commodity prices, underpriced leases of agricultural land, and budget subsidies helped strengthen the hand of oligarchs who dominate large parts of the economy, extract rents, and influence public institutions, including through direct representation in political parties and the Parliament. This has been a major impediment to development progress in critical areas. Public dissatisfaction with the pace and depth of the anticorruption measures, and concerns about the influence of vested interests on the Parliament and Government, remain strong.

4. Coordinated support from development partners has been critical in advancing the ambitious reforms supported by this operation. Since powerful vested interests stand in the way of reforms, building a coalition among Ukrainian civil society, reformers within government, and international development partners around key reforms has been critical to their progress. Financing and technical support from the World Bank, as envisioned by the FY17-21 CPF, in close coordination with the IMF, EU, US Treasury and USAID, and other bilateral partners is central to this effort. Support for reforms through the proposed PBG has been closely coordinated with the IMF's \$17.5 billion EFF program approved in March 2015, as well as the new \$3.9 billion IMF SBA program expected to be approved in December 2018. The pension and anticorruption reforms supported by the proposed PBG have also been supported by the IMF program. The reforms supported by the PBG have also been coordinated with the new Euro 1 billion EU Macro-Financial Assistance (MFA) for Ukraine.

5. The proposed PBG enables Ukraine to diversify its financing sources, mobilize private capital, and meet major financing needs in a challenging environment. Ukraine requires the equivalent of about \$11 billion in 2019 (8 percent of GDP) for debt repayments and to finance the budget. The plan is to raise about \$4.2 billion from external sources, and the remainder from domestic borrowing in local and foreign currency. The authorities are planning to raise about \$1 billion from the PBG and Euro 1 billion from the European Union Macro-Financial Assistance (MFA). A \$2 billion Eurobond was issued in October 2018, with additional Eurobonds planned in 2019. To avoid interfering with Ukraine's efforts to place Eurobonds and to diversify sources of financing, the PBG would pursue a private market transaction of Ukraine's IBRD-guaranteed borrowing. Market soundings indicate that Ukraine does not have unguaranteed access to such a private market transaction. However, initial expressions of interest from banks and subsequent discussions indicate that a \$750 million equivalent IBRD guarantee should allow Ukraine to mobilize about \$1 billion equivalent, with maturity of 10 years. The discussions also indicate that the instrument would need to be structured with some amortization of the unguaranteed portion within the first 5 years.

6. The PBG not only enables Ukraine to raise capital from a private market transaction, but also helps de-risk Ukraine in attracting additional necessary financing from Eurobonds. Ukraine's access to international capital markets remains constrained due to deteriorating market conditions, as well as macroeconomic vulnerabilities. While Ukraine issued a \$2 billion Eurobond in October 2018 (with a mix of 5-year and 10-year maturity) and a 15-year, \$3 billion Eurobond in September 2017, the yield on both has been one of the highest among emerging markets. The recent turbulence in the emerging markets has led to an increase in yields for Ukraine's Eurobonds, with the 10-year issue rising to 9.75 percent. Implementing the reforms supported by the proposed PBG and the IMF program would help bolster investor confidence, reduce Ukraine-specific risk, and help Ukraine attract additional financing at more attractive terms. Without this, all the necessary financing would need to be raised from shorter maturity and more expensive domestic and Eurobond markets, including increasing borrowing from state-owned banks and drawing down reserves.

7. **The proposed operation is subject to high risk.** Political risks arise from elections scheduled in 2019, which could lead to lack of progress or backtracking on reforms. Security risks come from the potential for intensified conflict in eastern Ukraine, which could lead to a deterioration in economic prospects. Macroeconomic risks come from high level of public debt, major financing needs, and the sensitivity of investor confidence to political and security risks. These risks are mitigated by the strong voice of Ukrainian civil society in advocating for continued reforms and by Ukraine's strong cooperation with the international community.

II. MACROECONOMIC POLICY FRAMEWORK

8. **Unprecedented shocks combined with a backlog of structural bottlenecks resulted in a deep economic crisis in 2014-2015, and a sharp increase in poverty.** The economy was hit by double shocks from the conflict in eastern Ukraine and a weak external environment, including lower global commodity prices. Real GDP contracted by 6.6 percent in 2014 and 10 percent in 2015. The currency depreciated by about 70 percent in 2014-2015, while the fiscal deficit, including Naftogaz, reached over 10 percent of GDP in 2014, with public and publicly guaranteed (PPG) debt rising sharply to 79.1 percent of GDP in 2015. The banking sector experienced deposit outflows, rising levels of nonperforming loans, and large numbers of bank failures, further reducing confidence in the economy. Poverty increased significantly in 2015 with the contraction of disposable incomes: real wages declined, underemployment increased, and Ukraine's unsustainable social benefits had to be frozen in nominal terms. Households were also impacted by higher energy prices in 2015, although the scaling up of the housing and utilities subsidy (HUS) program partly mitigated the impact. Moderate poverty (World Bank's national methodology for Ukraine) increased from 15.2 percent in 2014 to 26.9 percent in 2015, while poverty (under \$5.5/day in 2011 PPP) increased from 3.6 percent in 2014 to 7.8 percent in 2015.

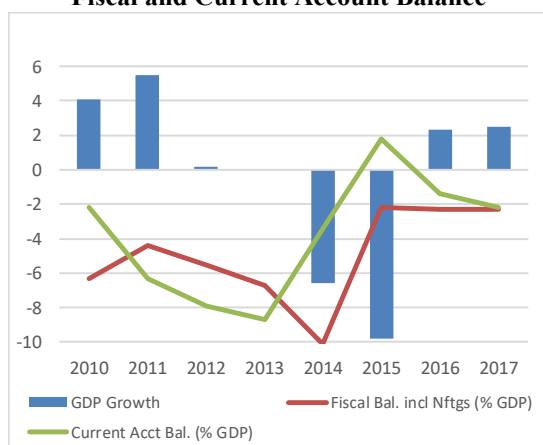
9. **The authorities undertook decisive reforms in 2014-2015 to stabilize the economy, reduce large imbalances, and cushion the impact of the shocks on the population.** Key reforms implemented with the support of World Bank DPLs and the IMF program included: (i) moving to a flexible exchange rate; (ii) undertaking significant fiscal consolidation; (iii) reforming energy tariffs to reduce a key quasi-fiscal deficit and strengthening the social safety net to cushion the impact on the poor; (iv) stabilizing the banking sector by putting in place a framework to resolve and recapitalize weak banks and strengthen supervision; (v) steps to streamline the business environment; (vi) steps to make public procurement more transparent, strengthen external audit, and improve public investment management; and (vii) establishing key anti-corruption institutions and asset disclosures for public officials.

2.1 Recent Economic Developments

10. **Economic growth has resumed at 2.3 percent in 2016, 2.5 percent in 2017, and 3.5 percent in the first half of 2018, but investor confidence and growth continue to be weighed down by the unfinished reform agenda.** The reforms helped to stabilize confidence after two years of sharp economic contraction. While the resumption of growth is a positive development, the recovery remains weak following the cumulative 16 percent contraction in 2014-15 (Figure 1). Investor confidence has been held back by concerns about delays in implementing key reforms and in completing reviews of the IMF program, given macroeconomic vulnerabilities. Growth has been driven in large part by the services sector, with wholesale and retail trade growing by 5 percent in 2017 and 4.5 percent in the first half of 2018 (due to higher wages and consumption). In 2017, growth suffered from a contraction in mining and electricity generation by about 6 percent due to the trade blockade in the Donbas region, and from a contraction in agriculture by 2.5 percent after the bumper harvest in 2016. In the first half of 2018, however, the acceleration of growth benefited from an early agriculture harvest (with agriculture growing by 11 percent) and a resumption of growth in the

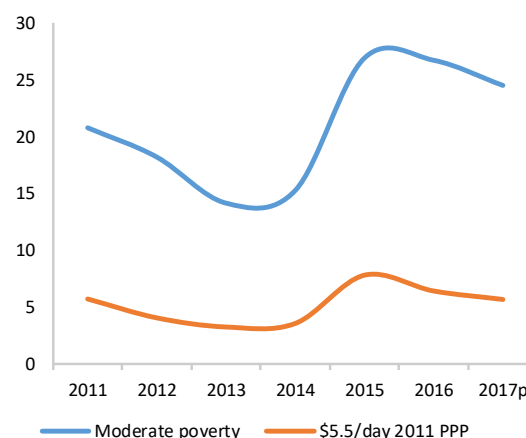
mining sector by 1.4 percent. The manufacturing, construction, and transport sectors grew strongly in 2017, but slowed in the first half of 2018, pointing toward weaknesses in investor confidence. On the demand side, consumption grew strongly by 6.7 percent in 2017 and 4.8 percent in the first half of 2018 due to higher pensions, wages (both in the public sector, as well as in the private sector due to strengthening economic activity and labor migration), and remittances. Fixed investment rebounded strongly by 18.3 percent in 2017 (and 20 percent in 2016) but slowed to 15.4 percent growth in the first half of 2018. Foreign direct investment (FDI) was weak at 2.1 percent of GDP in 2017, compared to 5 percent on average before the crisis. Exports grew by 4.8 percent in 2017 mostly due to improving commodity prices, while imports continued to grow by 8.7 percent due in large part to capital and intermediate goods, but also due to gradually recovering disposable incomes.

Figure 1: GDP Growth, Fiscal and Current Account Balance



Source: Ukrainian authorities and World Bank Staff estimates

Figure 2: Poverty



11. Inflation has been reduced since the 2014-2015 crisis, but the recent easing of fiscal policy has led to re-emerging inflationary pressures, an increase in the key policy rate, and higher credit costs. The monetary policy commitment of the National Bank of Ukraine (NBU) to medium-term price stability helped reduce inflation from a peak of 61 percent in April 2015 to 13.7 percent by end-2017. However, higher public-sector wages and pensions in 2017 led to an increase in inflation from 12.4 percent at end-2016 to 16.4 percent by September 2017. Given the NBU inflation target of 8+/-2 percent, the key policy rate has been raised periodically from 12.5 percent in May 2017 to 18 percent in September 2018, which has helped contain inflation at 9 percent in September 2018. However, this has also increased the cost of funds for local currency borrowing for both the government and the private sector. In the medium term the NBU remains committed to continue strengthening its monetary policy instruments, maintaining a flexible exchange rate regime, liberalizing capital and foreign exchange markets and further increasing transparency of its policies.

12. Poverty remains significantly above pre-crisis levels and faster economic growth is critical to raise household incomes going forward. The moderate poverty rate is estimated to have declined slightly to 24.5 percent in 2017 due to wage and pension growth and modest economic recovery (Figure 2). The poverty rate under \$5.5/day followed a similar trend down slightly to 5.7 percent in 2017. The average real wage was down 30 percent in January 2016 compared to pre-crisis levels but increased 19 percent in 2017 due in part to the sharp increase in public sector salaries and the minimum wage in 2017. The unemployment rate remained high at 9.5 percent in 2017 and underemployment remains significant.

13. The fiscal deficit has narrowed significantly since the 2014 crisis, but fiscal pressures and public debt remain high, with spending growing significantly in 2017, and revenues showing weakness in 2018. The overall fiscal deficit, including Naftogaz, narrowed from 10 percent of GDP in 2014 to 2.3 percent in 2016 (Table 1). This was achieved in large part through higher energy tariffs to reduce the Naftogaz deficit, and tight controls on spending, including a nominal freeze in pensions, social benefits, and wages. At the same time, fiscal pressures remained significant in 2016-2018 due to several key structural sources, including a cut in the payroll tax rate, weakly targeted social assistance, large public-sector employment including the civil service, health, and education workers, and weak tax administration. In 2016, the social security contribution rate was cut from 40 to 22 percent, resulting in a decline in payroll tax revenues to 5.5 percent of GDP (from 9.6 percent in 2015), significantly smaller than pension spending of 10.7 percent of GDP. In 2017, expenditures grew by 11.7 percent in real terms due to the doubling of the minimum wage and over 40 percent increase in wages of teachers and doctors, as well as higher spending on social programs. However, the fiscal deficit was within target at 2.3 percent of GDP in 2017 due to strong revenues, including the payroll tax (up 20 percent in real terms, due to the hike in wages), VAT (up 17 percent, due to higher proceeds from imports) and personal income tax (up 16 percent). In 2018, education and health sector wages were increased further. Given limited progress in right-sizing staffing, the public-sector wage bill is projected to reach 11.3 percent of GDP in 2018, up from 9.3 percent in 2016. In addition, general government revenues were 5 percent below the target in the first half of 2018, mainly due to weaker proceeds from excise tax, import VAT, payroll tax, and postponed Naftogaz dividend payments. Public and publicly guaranteed debt has declined from a peak of 80.9 percent of GDP in 2016 but remained high at 71.9 percent in 2017. The cost for recapitalization of PrivatBank was 4.5 percent of GDP in 2016 and 1.6 percent in 2017.

Table 1: Key Economic Indicators

	2012	2013	2014	2015	2016	2017	2018p	2019p	2020p	2021p
Nominal GDP, UAH <i>billion</i>	1,405	1,465	1,587	1,989	2,385	2,983	3,440	3,891	4,396	4,892
GDP per capita, US\$	4,080	4,216	3,119	2,122	2,176	2,645	2,975	3,220	3,548	3,831
Unemployment Rate (ILO defn), <i>percent</i>	7.5	7.2	9.3	9.1	9.3	9.2	9.0	8.4	7.8	7.1
Real GDP, <i>percent change</i>	0.2	0.0	-6.6	-9.8	2.3	2.5	3.5	2.9	3.4	3.8
Consumption, <i>percent change</i>	7.4	5.2	-6.2	-15.9	1.4	6.7	4.3	3.7	3.4	2.9
Investment, <i>percent change</i>	0.9	-8.4	-24.0	-9.2	20.1	18.2	13.7	8.4	10.4	9.6
Exports, <i>percent change</i>	-7.7	-8.1	-14.2	-13.2	-1.6	3.5	0.0	0.5	2.7	4.5
Imports, <i>percent change</i>	1.9	-3.5	-22.1	-17.9	8.4	12.2	5.8	4.4	5.5	5.0
Monetary and External										
GDP deflator, <i>percent change</i>	8.1	3.1	14.8	38.4	17.1	22.0	11.8	10.2	9.6	7.5
CPI (eop), <i>percent change</i>	-0.2	0.5	24.9	43.3	12.4	13.7	10.0	7.0	6.0	5.0
Credit to private sector, <i>percent change</i>	2.2	9.5	-15.6	-19.4	-3.7	2.1	11.5	11.5	12.0	12.5
Current Account Balance, <i>percent GDP</i>	-7.9	-8.7	-3.4	1.8	-1.4	-2.2	-2.9	-3.3	-3.4	-3.3
Foreign Direct Investment, <i>percent GDP</i>	3.9	2.1	0.2	3.3	3.5	2.3	2.0	2.2	2.3	2.5
Gross Reserves, <i>billion US\$, eop</i>	24.5	20.4	7.5	13.3	15.5	18.8	17.1	18.3	22.5	23.7
<i>In months of next year's imports</i>	2.9	3.5	1.8	3.1	3.4	3.3	2.8	2.9	3.3	3.2
External Debt, <i>percent GDP</i>	76.6	78.6	97.6	131.5	122.6	103.0	91.5	86.7	82.7	79.8
Fiscal										
Revenues, <i>percent GDP</i>	44.5	43.6	40.3	42.1	38.6	39.3	40.4	40.0	39.3	39.2
Expenditures, <i>percent GDP</i>	48.9	48.4	44.8	43.3	40.6	41.5	43.0	42.4	41.6	41.4
Fiscal Balance, <i>percent GDP</i>	-4.4	-4.8	-4.5	-1.2	-2.2	-2.2	-2.5	-2.3	-2.3	-2.3
Fiscal Bal. incl Naftogaz, <i>percent GDP</i>	-5.5	-6.7	-10.1	-2.2	-2.3	-2.2	-2.5	-2.3	-2.3	-2.3
PPG debt (eop), <i>percent GDP</i>	36.7	39.9	69.4	79.1	80.9	71.9	65.4	63.6	60.1	55.9

Source: Ukrainian authorities and World Bank Staff estimates

Note: Projections for 2018-2021 are based on a reform scenario (discussed in the outlook section)

14. The current account deficit has narrowed significantly since the 2014-2015 crisis, with international reserves at about 3 months of imports in 2018. In 2014-15, devaluation of the Hryvnia led to a compression of imports, with the current account deficit narrowing from 8.7 percent of GDP in 2013 to

a surplus of 1.8 percent in 2015. As economic activity and imports of intermediate and capital goods picked up in 2016-2017, the current account deficit widened to 2.2 percent of GDP in 2017. Merchandise exports grew 18 percent to \$39.7 billion in 2017, mostly due to improving commodity prices, while merchandise imports grew by 22 percent to \$49.3 billion driven by investment and intermediate goods, although both exports and imports remain considerably below their pre-crisis levels. In 2018, higher oil prices fueled import growth, while exports suffered from logistical difficulties in the Azov sea since July. The wider trade deficit was covered by 36 percent growth in remittances due to increased labor migration to neighboring EU countries which eased employment rules for Ukrainians. This is expected to help contain the current account deficit at 2.9 percent of GDP in 2018. International reserves strengthened from \$13.3 billion at end-2015 to \$18.8 billion (equal to 3.3 months of imports) at end-2017 but have declined to \$17.2 billion in August 2018. The composition of external current account financing is tilted toward public sector borrowing, with foreign direct investment (FDI) amounting to \$2.2 billion in 2017, compared to \$6.9 billion in 2012. The exchange rate has remained relatively stable in 2017-2018.

15. The banking sector has been stabilized and supervision has been strengthened, but state-owned banks now account for half of assets and credit to the private sector remains anemic due to high nonperforming loans. The banking system has been under great stress since 2014 due to the sharp economic downturn and deep-rooted history of related party lending. The authorities have put in place a framework to resolve and recapitalize banks and strengthen supervision, which resulted in 94 out of 182 banks being resolved since 2014 and largest and systemic bank, Privatbank, being nationalized at end-2016 due to the failure of its former owners to deliver on agreed recapitalization plans. This has significantly changed the financial landscape, with the share of state-owned banks (SOBs) rising to 54.2 percent in October 2018 from just 18 percent in 2013. The banking sector is expected to return to profit in 2018 after posting a cumulative loss of UAH 305.4 billion in 2014-17 due to the provisioning of non-performing or related loans. All large and mid-size banks have now undergone an asset quality review and related party diagnostic, and most large banks have returned to minimum capital adequacy requirements and completed related party unwinding plans. However, the share of nonperforming loans exceeds 50 percent. This is a serious impediment to the resumption of credit growth to the private sector, which contracted by 3.7 percent in 2016 (after a sharp cumulative contraction of 36 percent in 2014 and 2015) and remained essentially flat in 2017.

2.2 Macroeconomic Outlook and Debt Sustainability

16. Ukraine faces major financing needs in 2019 and 2020, which will require mobilizing sizable international financing to maintain macroeconomic stability. The fiscal framework targets a general government deficit of 2.3 percent of GDP in 2019. Furthermore, debt repayments (to the IMF, Eurobonds, and domestic bonds in foreign exchange and local currency) amount to a total of 5.6 percent of GDP in 2019. Financing the fiscal deficit and repaying debt will thus require new borrowing equivalent to \$11 billion in 2019 (8 percent of GDP), including about \$4.2 billion planned from external sources, with the rest raised domestically. In order to raise the necessary external financing on affordable terms, it is critical to secure approval of the new IMF Stand-By Arrangement by end-2018.

17. Meeting the fiscal deficit targets for 2019-2021 will require reforms to strengthen public finances, including the reforms supported by this proposed PBG. Not exceeding the fiscal deficit target of 2.3 percent of GDP in 2019-2021 is critical to manage macroeconomic vulnerabilities and reduce public debt to under 60 percent of GDP by 2021 (Table 2). To this end, the approval and implementation of a budget for 2019 that is credible, affordable, and in line with the deficit target is essential. Careful implementation of the pension, health, and housing utility subsidy reforms supported by the PBG, as well as the education and public administration reforms, would contribute to addressing the spending pressures in these areas, while also improving the effectiveness of these public services and social benefits. The pension reform helps

stabilize pension spending at up to 10.5 percent of GDP. Improved targeting of housing utility subsidies (HUS) helps consolidate a program that has grown to cover a sizable portion of the population. This contributes to a consolidation of social assistance spending from 5.1 percent of GDP in 2018 to 3.4 percent in 2021. The health, education, and public administration reforms are expected to consolidate the oversized hospital and school network and public-sector footprint over time. In implementing these reforms, it will be particularly important to make further wage increases contingent on concrete measures to optimize the school and hospital network and public-sector staffing. This would contribute to keeping the public-sector wage bill at current levels. In addition, it will be important to avoid measures that would undermine revenues, including proposals to replace the corporate income tax with a capital exit tax (which would result in the loss of a major revenue source in a challenging fiscal environment). The IMF SBA program also requires approval of an acceptable 2019 budget.

Table 2: Fiscal Framework

	2012	2013	2014	2015	2016	2017	2018p	2019p	2020p	2021p
Revenues	44.5	43.6	40.3	42.1	38.6	39.3	40.4	40.0	39.3	39.2
Tax revenues	38.9	37.9	35.4	35.5	33.1	34.2	35.8	35.6	35.5	35.5
Personal Income tax	4.8	5.0	4.8	5.1	5.8	6.2	6.7	6.9	7.1	7.2
Corporate profit tax	4.0	3.8	2.5	2.0	2.5	2.5	3.0	2.6	2.6	2.6
Payroll tax	13.0	13.3	11.6	9.6	5.5	6.2	6.9	6.8	7.0	7.1
VAT	9.8	8.8	8.8	9.0	9.9	10.5	11.1	10.7	10.5	10.5
Excise tax	2.7	2.5	2.8	3.6	4.3	4.1	3.8	3.8	3.7	3.7
Non-tax revenues	5.6	5.7	4.9	6.6	5.5	4.2	4.7	4.5	3.8	3.8
Expenditures	48.9	48.4	44.8	43.3	40.6	41.5	43.0	42.4	41.6	41.4
Current expenditures	45.7	46.2	43.7	40.7	37.5	38.1	38.9	38.4	37.6	37.4
Wages and compensation	11.2	11.5	10.2	9.4	9.3	10.6	11.2	11.1	11.4	11.3
Goods and services	7.4	7.1	7.4	7.4	6.7	6.7	6.6	6.9	6.8	6.8
Interest payments	1.9	2.5	3.3	4.2	4.1	3.7	3.9	3.8	3.5	3.5
Social benefits	22.1	23.1	20.5	18.4	16.3	15.5	16.4	15.2	14.8	14.7
Pensions	16.6	17.2	15.4	13.4	10.7	9.8	10.4	10.3	10.3	10.4
Social programs	3.9	3.9	3.7	3.8	4.6	4.9	5.1	4.0	3.5	3.4
Capital expenditures	2.9	2.0	1.3	2.4	3.1	3.3	3.8	3.8	4.0	4.0
Gen. Govt Balance	-4.4	-4.8	-4.5	-1.2	-2.2	-2.2	-2.5	-2.3	-2.3	-2.2
Gen. Govt Bal. incl. Nftgz	-5.5	-6.7	-10.1	-2.1	-2.3	-2.3	-2.5	-2.3	-2.3	-2.2
Bank Recap & DGF	0.0	0.1	1.7	2.3	5.7	3.0	0.0	0.4	0.3	0.0
External debt amortization	2.1	2.6	2.9	1.3	0.4	0.8	2.0	2.5	2.9	2.2

Source: Ukrainian authorities and World Bank Staff estimates

Note: Projections for 2018-2021 are based on the reform scenario (discussed in this section)

18. Sustained reform momentum, including implementation of the reforms supported by the PBG and the IMF program would send an important signal to investors and help support growth in 2019-2021 in a challenging economic environment. Ukraine faces challenges from the 2019 elections, a difficult financing environment for emerging markets coupled with major financing needs, and the projected softening of commodity prices. In this context, implementing the reforms supported by this operation and the IMF program would help meet financing needs, address macroeconomic vulnerabilities, and send an important signal to strengthen investor confidence. Under this reform scenario, which forms the baseline in our outlook, growth is projected at 2.9 percent in 2019 and 3.4 percent in 2020 after election related uncertainties abate. Growth would be supported by the services and manufacturing sectors, with agriculture and mining remaining relatively flat as commodity prices soften slightly. Consumption growth is projected to remain robust at 3.3 percent in the medium term due to higher wages and remittances, while investment growth is projected to pick up after elections. Supporting growth at these levels in 2019-2020 will require sustained reform momentum, including implementing the recently approved reforms (High Anticorruption Court, State-Owned Banks, and resolution of NPLs) and also moving forward with unfinished reforms (such as the opening of agricultural land markets). By contrast, if reforms do not progress and IMF reviews are not

completed, overall growth could fall below 2 percent as investor confidence deteriorates, macroeconomic vulnerabilities intensify, and financing difficulties force a compression in domestic demand.

Table 3: Balance of Payments Financing Requirements and Sources (US\$ billions)

	2017	2018	2019	2020	2021
Financing requirements (US\$ Bn)	57.6	55.8	45.4	49.2	52.3
Current account deficit	2.4	3.6	4.5	5.0	5.3
Public redemptions	3.3	4.2	4.0	5.0	4.7
LT private debt amortization (incl. portfolio)	24.0	21.8	11.9	14.1	14.0
ST private debt and trade credit	27.9	26.2	25.0	25.1	28.3
Financing Sources (US\$ Bn)	57.6	55.8	45.4	49.2	52.3
FDI	2.2	2.5	3.0	3.5	4.0
Public borrowing	6.8	3.9	7.3	6.1	5.8
LT private debt disbursement (incl. portfolio)	25.1	22.7	11.2	15.5	15.7
ST private debt disbursements	26.2	25.0	25.1	28.3	28.0
Drawdown in reserves	-2.7	1.7	-1.2	-4.2	-1.2

Source: Ukrainian authorities and World Bank Staff estimates

Note: Projections for 2018-2021 are based on the reform scenario

19. Higher exports and FDI as well as maintaining cooperation with the IMF and other official creditors underpin external sustainability. The current account deficit is projected to widen to 3.4 percent of GDP in 2020 as softer commodity prices impact traditional exports, while imports continue to grow (Table 3). Furthermore, public debt redemptions on Eurobonds and other debt are projected to pick up to \$5.0 billion in 2020. In this context, financing the current account and external debt amortization will require both continued cooperation with the IMF and other official creditors, as well as a recovery of FDI to \$4.0 billion by 2021. Implementing the reforms supported by this operation and addressing further unfinished reforms going forward are expected to help support growth of FDI and secure financing from official creditors. Progress on the structural reform agenda is also expected to help boost nontraditional and higher-value added exports (such as food processing, light manufacturing, IT services) in the medium term. This would enable a further buildup of international reserves to over 3 months of imports in 2021. Continued strong remittances at about 8 percent of GDP in 2019-2021 are also an important anchor of external sustainability. Ukraine's new SBA program, once approved, is expected to run through end-2019, but continued cooperation with the IMF and other IFIs beyond that date will be important to safeguard external sustainability.

Figure 3: Public and Publicly Guaranteed Debt (percent of GDP)

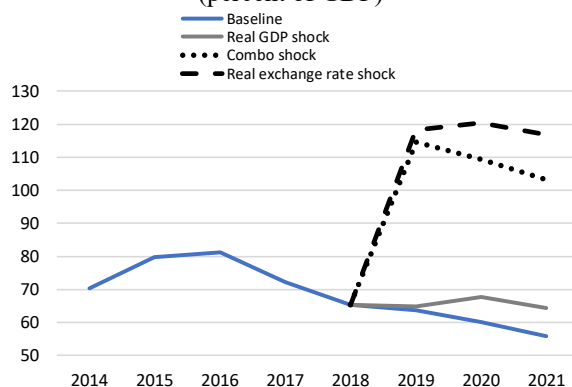
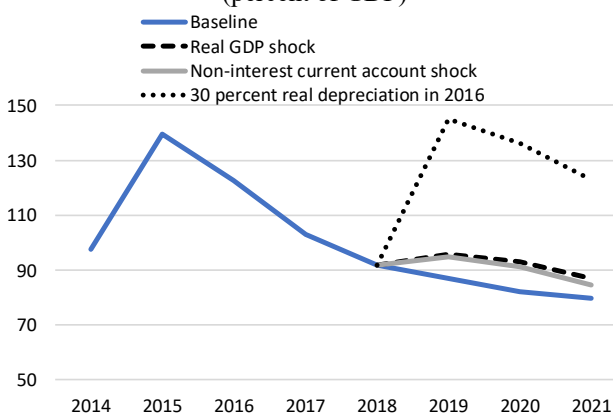


Figure 4: External Debt (percent of GDP)



Source: World Bank staff estimates.

Note: Projections for 2018-2021 are based on the reform scenario

20. **The Debt Sustainability Analysis (DSA) shows that while public and external debt are projected to decline in the baseline scenario, both are highly vulnerable to shocks.** The baseline DSA projections are consistent with the overall macroeconomic framework, including: gradual acceleration of economic growth; successful implementation of the fiscal program to meet deficit targets; a stable exchange rate; and continued official financing inflows along with a recovery of FDI and portfolio investment.

- **Public Sector DSA:** In the baseline scenario with reforms, public and publicly guaranteed (PPG) debt is projected to decline to around 56 percent of GDP by 2021 due to the acceleration of growth and a stable fiscal deficit. Risks to the base case are high. Exchange rate risks are particularly critical given the large share of FX denominated debt (about 67 percent of total PPG). A real exchange rate shock⁴ could push the PPG debt level to 118 percent of GDP in 2019 (Figure 3), while a combined macro-fiscal shock⁵ would increase PPG debt to 115 percent of GDP.
- **External DSA:** In the baseline scenario with reforms, total external debt is projected to decline from a peak of 139 percent of GDP in 2015 to 80 percent in 2021. As with public debt, the external debt trajectory is subject to high risks. The external debt adjustment path is also particularly sensitive to exchange rate shocks. A 30 percent real depreciation shock in 2019 would drive debt to about 145 percent of GDP. Lower GDP growth (by half a historical standard deviation or 2.5 percentage points) and a non-interest current account shock (one percentage point above the baseline) would keep the external debt to GDP ratio above 90 percent in the next two years (Figure 4).

21. **Ukraine's overall macroeconomic policy framework is adequate for this operation.** The key pillars underpinning the adequacy of the macroeconomic framework include a credible commitment by the authorities to implementing the reforms supported by this operation and the IMF program, as well as to pursue additional unfinished reforms in 2019-2020. This would help to: (i) support growth of 2.9 percent in 2019 and 3.4 percent in 2020 by bolstering investor confidence; (ii) meet the fiscal deficit target of 2.3 percent of GDP in 2019-2021 to gradually reduce public debt; (iii) raise exports and attract FDI to support external sustainability; and (iv) support credit growth to the private sector by strengthening the governance of state owned banks and reducing nonperforming loans. The adequacy of the macroeconomic framework is supported by this proposed operation, as well as the expected 14-month, \$3.9 billion IMF Standby Arrangement (SBA) for Ukraine. The authorities reached staff level agreement on the new IMF SBA on October 19, with approval of the program expected in December 2018, once the prior actions on the 2019 budget are met. This will replace the \$17.5b IMF EFF program for Ukraine approved in March 2015 (with \$8.7 billion disbursed to date).

22. **Ukraine's macroeconomic framework is subject to considerable risks.** One of the greatest risks is the lack of progress or even backtracking on reforms in a complex political environment, particularly given Presidential and Parliamentary elections scheduled for 2019. In addition, there are risks of an escalation of the conflict in eastern Ukraine and a deterioration in the global economic environment. If any of these risks materialize, economic growth could slow considerably, which would undermine political and social stability since disposable incomes and living standards are already lower than pre-crisis levels. Further, Ukraine faces large public debt repayments over the next three years and significant medium-term expenditures pressures. If reforms to address fiscal vulnerabilities do not progress, Ukraine will need to rely on ad-hoc revenue measures and expenditure cuts, more expensive and shorter maturity borrowing from domestic and Eurobond

⁴ Maximum historical movement of the exchange rate and pass-through to inflation with elasticity of 0.3.

⁵ Shock size and duration based on all macro-fiscal shocks (constant primary balance shock, real GDP growth shock, interest rate shock and real exchange rate shock).

markets, including from state owned banks, and drawing down reserves, which would undermine macroeconomic stability and development outcomes. This would also lead to lower investor confidence and growth, higher inflation, and pressures on the exchange rate and international reserves. If reforms to bolster the financial sector do not progress, confidence in banks could deteriorate, which would also undermine both growth prospects and macroeconomic stability. Finally, if Ukraine is unable to attract more FDI and unlock planned external financing from the IMF and other official creditors, it would face difficulty in meeting external payments, which would necessitate further import and demand compression. These risks are mitigated in large part by a coalition among Ukrainian civil society, reformers in government, and development partners actively advocating for the most critical reforms. The World Bank and the IMF work closely to monitor macroeconomic developments and to support the design and implementation of key reforms.

2.3 IMF Relations

23. **This proposed PBG is closely coordinated with the IMF, including in supporting the design and implementation of key reforms, and in monitoring the macroeconomic and fiscal program.** The IMF Board of Executive Directors approved a four-year, US\$17.5b EFF for Ukraine on March 11, 2015 under the IMF's exceptional access policy. The First Review was completed on July 2015, the Second Review was approved in September 2016, and the Third Review was approved in April 2017, with \$8.7 billion in total disbursed to date. The authorities reached staff level agreement on a new IMF SBA in October 2018, with approval of the program expected in December 2018, once the prior actions on the 2019 budget are met. The close coordination between the PBG and the IMF program has been instrumental in advancing reforms in a challenging environment. The pension and anticorruption reforms in the PBG have also been supported by the IMF program.

III. THE GOVERNMENT'S PROGRAM

24. **A new Government took office in April 2016 and issued a program and action plan covering a broad reform agenda that is in line with the development objectives of the proposed PBG.** An updated Medium-Term Action Plan for 2017-2020 was approved by the Cabinet of Ministers in April 2017 and sets a goal of "increasing standards of living and quality of life via sustainable economic development". The Action Plan sets out five strategic priorities:

- **Economic growth:** by increasing exports and investments, implementing tax and customs reforms, deregulation, land reform, privatization, reforming the energy sector and maintaining macroeconomic stability by continuing fiscal consolidation;
- **Good governance:** by reforming public administration, decentralization, and public finances;
- **Human capital development:** by reforming education and healthcare systems, and social support;
- **Supremacy of law and combating corruption:** by improving anticorruption institutions, ensuring equal access to justice, and providing efficient protection of ownership rights; and
- **Security and defense:** by protecting sovereignty and territorial integrity and public security.

The Government's Medium-Term Action Plan for 2017-2020 underpins its ambitious agenda across multiple areas. It also represents the basis for medium-term budget planning, the Government's annual detailed actions plans, strategic plans of ministries and other government agencies.

25. **The proposed PBG builds on renewed momentum to advance ambitious reforms in the window of opportunity before elections scheduled in 2019.** Since the summer of 2016, renewed reform momentum has emerged with the adjustment of heating tariffs in July 2016, publication of asset declarations in October 2016, and the nationalization of PrivatBank in December 2016. Since summer 2017, with the support of the PBG, considerable progress has been made in designing and implementing a new phase of ambitious reforms, including in areas where reform was previously considered unlikely, such as pensions, health care, the anticorruption court, and land markets. The pension reform law was enacted in October 2017, the health reform law was enacted in November 2017, the High Anti-Corruption Court (HACC) law was enacted in June 2018, and the state-owned banking law was approved in July 2018. It will be important to carefully implement these historic reforms. Extensive discussions on design principles of land reform led to the preparation of a draft land turnover law in fall 2017, and significant measures have been taken to improve the transparency of land records and address other pre-requisites for opening agricultural land markets, but a decision to move forward with the turnover law.

IV. THE PROPOSED OPERATION

3.1 Prior Actions, Results, and Analytical Underpinnings

26. **The proposed operation supports reforms that address critical structural underpinnings of Ukraine's weak growth recovery and continued macro-fiscal vulnerabilities.** The program development objective is to: (i) strengthen factor markets and institutions; and (ii) promote fiscally sustainable and effective services. The reforms under the first pillar address major structural impediments to investment and growth in Ukraine, including in state-owned banks, non-performing loans, agricultural land transactions, and anticorruption. The reforms under the second pillar address major expenditure pressures from pensions, housing utility subsidies, and health, while improving the effectiveness of these critical public services and social benefits. Overall, the reform program not only addresses key structural bottlenecks but also sends an important signal to investors about Ukraine's ability to sustain the reform momentum and address macroeconomic vulnerabilities in a complicated political environment ahead of the 2019 elections.⁶

Pillar 1: Strengthen Factor Markets and Institutions

27. **The reforms in the financial sector, agricultural land markets, and anticorruption contribute to tackling major bottlenecks to investment and growth.** Strengthening the governance of state-owned banks and putting in place measures to enable resolution of non-performing loans (NPLs) would enable a gradual resumption of lending to the private sector. Strengthening the transparency and security of land rights creates the conditions to establish agricultural land markets and improves incentives to invest and improve productivity. Deeper anticorruption reforms address investor concerns about the lack of a level playing field and should help in attracting foreign investment. These reforms are also expected, over time, to help Ukraine shift from a reliance on commodity exports (crops and metals) toward higher value-added exports integrated with European and international production chains.

⁶ The reforms supported by the PBG were completed between October 2017 and November 2018. Discussions on the design of the reforms started earlier in 2017. Given the complexity and ambition of the reforms, implementation for some of the reforms is expected to continue into 2019. As such, it was agreed that the baseline date for the results indicators would be 2016 and the target date would be 2019.

28. A large state-owned banking sector and high share of non-performing loans constrain efficient financial intermediation and credit growth to the private sector. The banking system has been under considerable stress since 2014 due to the sharp economic downturn and a history of widespread related party lending. The authorities responded with major reforms in the financial sector supported by World Bank Development Policy Loans (DPLs) in 2014-2015 which put in place a framework to resolve and recapitalize banks and strengthen supervision. As a result, a total of 94 out of 182 banks have been resolved since 2014. Notably, PrivatBank, the largest systemic bank in Ukraine with a large related party portfolio, was nationalized in December 2016, following the failure of the former owners to implement the agreed recapitalization and restructuring plans. While these reforms have helped strengthen financial sector stability, a large share of state-owned banks and a high share of non-performing loans continue to undermine the efficiency of financial intermediation and credit growth to the private sector. Specifically, since state-owned banks (SOBs) are now 54.2 percent of the banking sector and overall non-performing loans (NPLs) are more than 50 percent, reforms to strengthen corporate governance of SOBs and put in place effective NPL workout mechanisms are critical to increase credit growth to the private sector in an efficient and sustainable manner.

29. Independent governance of SOBs and a strategy to reduce the role of the state in the banking sector are essential to improve the efficiency of credit allocation in the banking sector. SOBs in Ukraine have historically operated under the influence of significant political and vested interests that resulted in low credit quality and high contingent fiscal liabilities. PrivatBank currently has a supervisory board with 4 independent members out of a total of 7 board members. Ukrgazbank was recently provided with two third independent supervisory board. However, Ukraine has two other SOBs—Oschadbank and, Ukreximbank—which remain without independent supervisory boards and are susceptible to significant political influence. Together, the four SOBs account for 54.2 percent of banking sector assets, while the NPL ratio of SOBs is about 70 percent, much higher than in private banks. With the support of the World Bank, IMF, and EBRD, the authorities worked on amendments to Article 7 of the Banking Law to strengthen corporate governance and risk management by introducing two third independent supervisory boards at banks that are wholly state-owned. The State-Owned Bank Law (containing the necessary amendments to Article 7 of the banking law) faced stiff opposition from vested interests, was approved by Rada in July 2018 and enacted on November 2018. It is envisioned that under professional and independent supervisory boards, each SOB will adopt its own strategy and business plan to establish a roadmap for privatization. To guide this process, the Cabinet of Ministers of Ukraine endorsed a revised strategy for SOBs in February 2018 to set time-bound targets and guidance on key reform objectives. Under the strategy, the share of state ownership of banks would decline from the current 54.2 percent to below 24 percent by 2022 by attracting strategic international investment. The strategy also targets reducing lending to state-owned enterprises and ensuring that the share of government bonds in SOBs assets will not exceed 25 percent. A special independent committee will also be created to make key decisions on centralized resolution of big corporate NPLs.

30. Strengthening the resolution framework for NPLs is critical to restore credit growth to the private sector. An assessment of the NPL resolution framework by the World Bank identified significant shortcomings on multiple fronts, including the regulatory and judicial system, insolvency, debt enforcement and foreclosure, and taxation. The assessment identified a number of initial measures that are priorities and where realistic opportunities for improvement exist in the short term. The authorities have taken action on some of these measures. Specifically, the authorities have relaxed the 25 percent ceiling for provisioning expenses and issued unified interpretations for tax legislation clarifying NPL related issues, which could trigger NPL resolution via restructuring, partial forgiveness, foreclosure, write offs and sale of NPLs to third parties. In addition, the Law on increasing creditors' rights (approved by Rada in July 2018 and enacted in November 2018) is expected to substantially strengthen the debt enforcement and foreclosure process.

Beyond these measures, the corporate insolvency framework also needs to be improved significantly going forward, as the insolvency framework and the inefficient judicial system remain major impediments to NPL resolution in Ukraine.

Prior Action 1: *Enacted Law No. 2491-VIII “On Improving the Functioning of the Financial Sector” dated July 5, 2018 to establish independent supervisory boards and strengthen risk management at State Owned Banks (SOBs); and adopted a strategy for the development of SOBs which establishes a roadmap for gradual divestiture.*

Prior Action 2: *Enacted Law No. 2245-VIII “On Amendments to the Tax Code” dated December 7, 2017 to remove the 25 percent ceiling for provisioning expenses and issued orders on the tax treatment of transactions involving nonperforming loans; and enacted Law No. 2478-VIII “On Resumption of Lending” dated July 3, 2018 to increase creditors’ rights.*

Expected Result: Number of SOB supervisory boards with at least two-thirds of independent board members increases from 1 in 2016 to 4 in 2019.

Creating the conditions to establish a transparent market for agricultural land transactions

31. The moratorium on agricultural land sales and weaknesses in the transparency of land rights contribute to low investment and productivity in the agriculture sector. Ukraine has the largest endowment of agricultural land in Europe—42.7 million hectares, including 33 million hectares of arable land, compared to 18 million hectares of arable land in France, 12 million hectares in Germany, and 11 million hectares in Poland. However, agricultural productivity in Ukraine is much lower than in other European countries: \$413 per hectare in 2014, compared to \$1,142 in Poland, \$1,507 in Germany, and \$2,444 in France. The problem is that the moratorium on agricultural land sales (in place since 2001) undermines incentives to invest, improve productivity, and manage land in a sustainable manner, such as through irrigation investments, perennials, crop rotation, and shifts into higher value-added products. The moratorium also undermines access to credit for small and medium producers because land cannot be used as collateral. As a result, Ukraine not only has lower yields in crops but also focuses on lower-value added primary products. In addition to the moratorium, weaknesses in the transparency and security of land rights are another major impediment to attracting investment in agriculture. Significant errors in the land cadaster and registry have led to insecurity of land rights and high transaction costs and would also undermine the use of land as collateral when the moratorium is lifted. Second, the lack of price registration for rental contracts and the limited number of transactions outside of the moratorium means that a transparent record of land values and leases is unavailable. Third, the low registration of state agricultural land has been a major source of nontransparent practices. Together, these factors lead to a mutually reinforcing cycle of low investment and productivity, informality, and lost budget revenues in a sector with great potential to drive investment and growth in Ukraine.

32. Major steps have been taken over the past year to strengthen the transparency of land rights and transactions, in preparation for lifting the moratorium going forward. These steps are critical prerequisites for the establishment of a transparent, efficient, and stable agriculture land market once the moratorium is lifted. The most important steps taken include: (i) the land governance monitoring resolution # 639, adopted by the Cabinet of Ministers in August 2017, which requires the authorities to collect, store, and publish the data and indicators, at the rayon, regional, and national level, on land transactions, tax, disputes, privatization and expropriation, by categories of landowners and land users; (ii) integrating the cadaster and registry data and correcting errors in the cadaster not requiring court rulings; (iii) a cabinet resolution to commit to the registration of all state land by 2020 in line with a specified methodology; (iv)

establishing an Anti-Raider Commission to investigate cases of fraud in the land registration process; (v) upgrading the system of providing free legal support for land registration, land lease, disputes, inheritance, and sales; and (vi) preparing a system for automatic registration and publication of rental contracts and prices (expected to be completed by end-2018); and (vii) piloting an electronic auction platform for land transactions (although the full rollout will require an amendment to the land code that could be part of the turnover law). In addition, the authorities have developed a Partial Credit Guarantee (PCG) scheme, with World Bank support, to provide access to finance for small farmers. This is critical to ensure that small farmers have the financial capacity to participate in the land market so that the lifting of the moratorium is not associated with a concentration of land ownership. It is envisioned that the PCG instrument could be initially capitalized from the state budget and allow commercial banks to provide loans to small farmers at an interest rate to be determined by banks.

33. As part of the effort to lift the moratorium and establish an agricultural land market, the authorities have drafted a land turnover law, and a communication effort is underway to better inform the population. A working group on land reform under the guidance of the Prime Minister and with support from the World Bank has drafted the land turnover law which would lift the moratorium and establish a transparent market for agricultural land sales, with adequate safeguards, and the ability to use land as collateral. The safeguards include a restriction on foreign ownership; a limit on land accumulation of 200 hectares for individuals and 1000 hectares for family farms and legal entities with a 3-year history of operation; and a minimum price based on the normative land value. The prospects of moving forward with the law have been complicated by the 2019 elections, and public perception on lifting the moratorium has been undermined by misinformation from those who benefit from low land rents. The authorities have made clear that a decision to move forward with the turnover law will require a shift in public perception. A communications campaign since April 2018 has stimulated discussion at the grassroots level about the need for land reform. This has led to a significant increase in publications in traditional and social media, accompanied by several regional events. Furthermore, in August 2018, the European Court on Human Rights ruled that the moratorium violates the constitutional property rights of landowners in Ukraine.

Prior Action 3: Strengthened the transparency of agriculture land records by: (i) integrating the cadaster and the registry data; (ii) approving Cabinet Decision No. 31 dated August 22, 2018 to commit to the registration of all state agricultural land by December 2020; and (iii) establishing a land governance monitoring system including rental and sales prices.

Expected Result: Amount of registered state land increases from 1 million hectares in 2016 to 4 million hectares in 2019.

Strengthening anticorruption institutions

34. A major missing part in Ukraine's new anticorruption architecture is an independent anticorruption court to provide impartial decisions on corruption cases. Ukraine adopted a new set of anti-corruption laws in 2014-15 with the support of the World Bank and other development partners. Most notably, these laws established the National Anti-Corruption Bureau (NABU, with investigative functions), the Special Anticorruption Prosecutor Office (SAPO, responsible for anticorruption prosecutions), and the National Agency for Corruption Prevention (NACP, responsible for asset declarations of persons with public functions, and conflict of interest provisions). As of May 31, 2018, NABU investigated a total of 611 cases and sent 140 cases to court. However, given major weaknesses in Ukraine's judicial system, an independent anticorruption court is critical to provide an impartial decision on the cases. In more than a third of the cases prepared by NABU, trials have not yet started; and in one of the highest profile cases involving the arrest of the former head of the state fiscal service in March 2017, it took three days to find a judge to hear the case.

This has led to widespread frustration among citizens and undermined trust in the government's commitment to combating grand corruption. The creation of an independent anticorruption court, with both first instance and appellate chambers, has been promoted by civil society, anticorruption NGOs, and Ukraine's international partners including the IMF, the EU, the World Bank, and the G7.

35. The law to create an independent High Anti-Corruption Court was approved by Rada and enacted by the President in June 2018. The President submitted the draft law to Parliament on December 21, 2017, following recommendations from the Venice Commission of the Council of Europe in October 2017 on previous draft laws. In October 2017, the Venice Commission strongly recommended that Ukraine requires an independent anticorruption court—it noted that while judicial reforms are underway, it will take time for courts to improve to a level that could provide independent hearings for corruption cases. Following the approval of the draft law in the first reading on March 1, 2018, extensive discussions led to amendments to bring the draft law into line with the recommendations of the Venice Commission. The Law provides for the creation of a specialized court with both first instance and appellate chambers that will hear those corruption cases that fall within NABU's jurisdiction over high government officials. Importantly, to ensure that the HACC is staffed with independent and credible judges, the HACC Law establishes a panel of international experts who will play a crucial role in the selection of HACC judges along with Ukraine's High Qualification Commission, as recommended by the Venice Commission. The international panel is given the authority to veto candidates that it believes lack the qualifications, experience or ethics to be independent judges. The Venice Commission recognized that this was an exceptional solution but felt that it was necessary given the need to establish the credibility of the HACC from its inception.

Prior Action 4: Enacted Law No. 2447-VIII "On the High Anti-Corruption Court", dated June 7, 2018 to establish a specialized High Anti-Corruption Court comprised of independent judges selected in line with the recommendations of the Venice Commission.

Expected Result: Number of cases under review by the High Anti-Corruption Court increases from 0 in 2016 to 25 in 2019.

Pillar 2: Promote fiscally sustainable and effective services

36. The reforms under this pillar help to strengthen the effectiveness of critical public services and social benefits in Ukraine, while addressing major expenditure pressures from these areas. Ukraine has historically spent a large share of GDP on the public sector, but the effectiveness of public services and social benefits has been low. Public expenditures were 47 percent of GDP on average during 2010-2015 in Ukraine, compared to 35 percent on average in the Europe and Central Asia (ECA) region. Despite high spending, the social outcomes and the quality of services have been weak. Spending on social benefits (pensions and social assistance) has ranked among the highest in the region (peaking at 23 percent of GDP in 2013 and remaining high at 16.3 percent in 2016). However, pension benefits have been low, and a high share of social assistance has gone to relatively higher income households. Public dissatisfaction with health services has been high and life expectancy is considerably lower than the EU average. Ukraine has made progress in reducing the size of public spending, with general government expenditures declining from 48.5 percent of GDP in 2013 to 41.5 percent in 2017. However, a large part of this consolidation was achieved through a freeze in wages and pensions in nominal terms, together with high inflation. The reforms under this pillar introduce the structural changes necessary to strengthen the effectiveness of pensions, housing utility subsidies, and health care in Ukraine in a fiscally sustainable manner.

Enhancing adequacy and sustainability of old age pension benefits

37. **The pension system in Ukraine has for an extended period constituted a major fiscal burden, provided inadequate benefits for elderly population, and encouraged informality.** Pension expenditures were 10.7 percent of GDP in 2016 (excluding financing by the central budget of some public programs operated by the PFU), with a pension fund deficit of about 5 percent of GDP after the cut in payroll tax rate from 40 to 22 percent in 2016. Despite high pension expenditures, the average old age pension was only about \$2 a day in 2016, and the pension system encouraged informality and undermined incentives to contribute. The key problem has been a weak link between contributions and benefits, along with a host of categorical and early retirement provisions. Without reform, the pension system would have experienced either a large increase in cost or a significant fall in the replacement rate for old age benefits. The reform supported by this operation is intended to stabilize pension expenditures as a share of GDP, while at the same time helping to achieve a slight increase in the replacement rate.

38. **The pension reform law was approved and enacted in October 2017.** Since 2017, the World Bank worked closely with the government, in coordination with the IMF, to help design the pension reform law. The pension reform law adopted in October 2017 was designed to: (i) improve old-age benefits; (ii) strengthen incentives to contribute; and (iii) maintain pension expenditures stable at about 10.5 percent of GDP. The approved reform provides incentives to develop a longer history of contributions and retire later in exchange for better benefits. It also introduces clear rules of indexation and raised benefits for existing pensioners that had been frozen and eroded considerably in real terms since the economic crisis. The final approved law addressed many of the concerns that the World Bank and the IMF had raised on earlier versions. However, it contained two last minute provisions that would provide a flat guarantee and transitory social assistance to those over age 60 without adequate years of service under the new rules. This potential shortcoming was addressed through Cabinet resolutions adopted in January 2018 to establish a mechanism for means-testing the flat guarantee and transitory social assistance to those without adequate years of service. According to the Pension Fund of Ukraine, the number of transitory social assistance awards remained quite small in the first months of 2018. Second, the law also called for another draft law to introduce a funded pension scheme by January 2019, even though it will take much longer to develop the necessary conditions for its introduction in Ukraine. The Bank has engaged the authorities in a dialogue on prerequisites and design principles for introduction of a funded pillar system. It is important that additional initiatives in pension reform do not compromise the core objectives of the reform. In particular, introducing a funded pension pillar by January 2019 could undermine contributions to the existing pay-as-you-go (PAYG) pension system, create contingent fiscal liabilities, and face challenges regarding the readiness of the regulator and availability of financial instruments.

Prior Action 5: Enacted Law No. 2148-VIII “On Increase of Pensions” dated October 3, 2017 to improve fiscal sustainability, adequacy of old age benefits, and incentives to contribute by providing incentives to retire later in exchange for higher benefits and preserving the value of benefits over time through systematic indexation.

Expected Result: Average old age pension replacement rate increases from 27 percent in 2016 to 30 percent in 2019 and pension expenditures remain stable at about 10.5 percent of GDP in 2016 to 2019.

Improve targeting and fiscal sustainability of the housing and utilities subsidy (HUS) program

39. **The Housing Utility Subsidy (HUS) program played a major role in cushioning the impact of the sharp energy tariff increases in 2014-15, but the program has become large, costly, and poorly targeted.** In 2014-15, Ukraine significantly reduced fiscal costs and rents in the energy sector by raising

tariffs three-fold to the cost recovery level, while protecting the poor by putting in place the Housing and Utilities Subsidy (HUS) program. Today, however, the program has become too large and fiscally burdensome, covering about 40 percent of all households in Ukraine and costing an estimated 2.6 percent of GDP in 2017. Furthermore, a significant share of the HUS goes to households in the higher quintiles of the income distribution, indicating that targeting can improve significantly. In 2016, only 46 percent of the HUS subsidy went to households in the bottom 40 percent of the population. The reform to the HUS supported by this operation is intended to improve targeting and fiscal sustainability of the program, and help improve the overall sustainability of the social assistance system.

40. The authorities have adopted a number of HUS targeting measures as part of a transition from short-term emergency support toward a sustainable medium-term energy social assistance. At the request of the Prime Minister, the World Bank has supported Ukraine's efforts to improve the targeting of HUS. The Cabinet resolution # 329 approved on April 27, 2018 introduced a number of major measures to improve HUS targeting, following up on measures introduced in 2017. The key measures adopted during 2017 and 2018 include a reduction in the HUS allowance, stricter income assessment procedures, additional eligibility criteria including asset tests, and a minimum out-of-pocket payment. These measures will reduce eligibility, coverage and generosity of payments with significant fiscal savings. However, the savings could be partially eroded due to further tariff increases, potentially raising the need for additional targeting measures. A complementary and critical measure was adopted to strengthen the use of resources in the energy sector through monetization of energy subsidies at the level of utility companies (Cabinet Resolution #951, adopted November 8, 2017). The new system replaced the cumbersome payment offsets between the different actors in the gas and heating sector. Going forward, the authorities plan to gradually introduce consumer-level monetization of the HUS program to improve transparency and control of payments and provide further incentives for energy efficiency without compromising financial discipline in the utility sector.

Prior Action 6: Improved the Housing Utility Subsidy (HUS) program by: (i) revising social norms and parameters of the formula and introducing additional means-testing mechanisms; and (ii) monetizing the HUS settlement at the level of gas and heating utilities, as evidenced by Cabinet Resolution No. 329 dated April 27, 2018 and Cabinet Resolution No. 951 dated November 8, 2017.

Expected Results: Share of HUS going to bottom 40 percent of the population increases from 46 percent in 2016 to 50 percent in 2019.

Establishing the Energy Efficiency Fund

41. Ukraine is among the most intensive users of energy in the world, with the highly inefficient residential housing stock one of the greatest contributors to this inefficiency. Inefficient heating of residential buildings causes losses of about 50 percent of primary energy supplied. Of the 19 billion cubic meters of gas used for heating in Ukraine in 2016, about half could be saved through energy efficiency improvements in buildings. The overall investment needs necessary to realize this potential are estimated at \$60 billion and cannot be mobilized without participation from the private sector. Ukraine's total multi-family building stock (estimated at 80,000 high-rise buildings or 200,000 buildings including also smaller 5-story residential buildings) were privatized in the 1990s, with responsibility for maintenance and renovation shifted to homeowners and homeowners' associations (HOAs). However, a host of legal and regulatory barriers and market failures have impeded much needed investment in energy efficiency retrofits and modernization of residential buildings.

42. **The authorities have moved forward to establish an Energy Efficiency Fund (EEF) to support the support energy efficiency improvements in the residential building stock.** The approval of the “Law on the Energy Efficiency Fund” in July 2017, followed by the approval of the EEF charter and procedures for using budget funds in the operation of the EEF in December has created an instrument to address the bottlenecks in residential energy efficiency investments. The EEF is envisioned to facilitate the provision of state and donor-funded grants and bank loans to HOAs to finance the implementation of energy efficiency improvements in their buildings. The European Union (EU), Germany, IFC, and the World Bank have been supporting the government’s EEF initiative. The EU and Germany have committed to contribute up to EUR 80 million and EUR 10 million respectively to create a grant facility, which will provide grants to HOAs (via financial institutions) to co-finance the implementation of energy efficiency measures in multi-family buildings to complement the funding provided by the Ukrainian government. The World Bank and the IFC are providing technical assistance in supporting the establishment of the EEF. This follows the recent successful completion of the World Bank’s Energy Efficiency project which provided financing for energy efficiency investments. Going forward, it will be important to expeditiously put in place the EEF’s supervisory board and management team, develop operational policies and procedures, and receive necessary funds from the government for the charter capital and operational activities.

Prior Action 7: Adopted the charter of the Energy Efficiency Fund (EEF), including procedures for using budget funds for the operation of the EEF, as evidenced by Cabinet Resolution # 1099 dated December 20, 2017.

Expected Result: EEF becomes operational and initiates the provision of resources for building retrofits in 2019.

Transforming the financing of health care

43. **Ukraine spends a significant amount on health, but it is skewed toward a large hospital network, financing inputs rather than services, which distorts incentives and results in poor health outcomes.** Total public and private health spending—7.6 percent of GDP—has been above the global average for Ukraine’s income level. However, life expectancy at birth has been 10 years lower than the EU average, mainly due to excess mortality caused by non-communicable diseases, particularly among the male and rural population. Health financing has been skewed toward a large hospital network and is based on inputs rather than outputs. Inpatient institutions have absorbed more than 60 percent of the total health budget in recent years, while only about 10 percent has been allocated to specialized outpatient facilities, 9 percent to primary health care, and less than 2 percent to disease prevention. Ukraine has about 40 percent more hospital beds per capita than the EU average. This network consumes most of the available funding while often providing only very basic services. Such a system also undermines the adequacy of health treatment, leading to unnecessary increase in hospitalization rates and length of stay in inpatient facilities to justify the oversized hospital network. The average length of stay in Ukraine was 11.7 days in 2013, while the average for the European region was 8.6 days. Out of pocket payments account for half of health expenditures, which imposes financial risks on the vulnerable population and constrains access to care. The lack of adequate primary care is a major vulnerability for specific gender-disaggregated needs, including cardiovascular disease for men and maternal and neonatal care for women. Only 10 percent of Ukrainian citizens positively assessed the quality of health care according to a 2015 survey. The system also contributes to corruption in the sector. Public procurement in the health sector has been a major source of inefficiency and corruption.

44. **A historic transformation of the health system in Ukraine was launched through the package of two health reform laws approved by parliament in October 2017, and implementation will be an important challenge going forward.** The Law on Financial Guarantees for Health Care provides the

framework to transform the health system by: (i) creating a national purchasing agency for procurement of health services; (ii) modernizing primary health care by strengthening capacities of primary care personnel, improving infrastructure, and introducing eHealth and telemedicine solutions; (iii) defining a health benefit package; (iv) implementing capitation payments for primary care and diagnosis-related group (DRG) payments for hospital services; (v) addressing non-communicable diseases; and (vi) improving access to pharmaceuticals. The authorities recognize that implementing the newly approved health reform laws will be a major challenge given capacity constraints. In particular, it will be important to proactively coordinate the financing of the primary care roll out with the consolidation of the hospital network through an implementation plan. Also, the approved version of the law included a provision to target 5 percent of GDP health expenditure and 250 percent of average wage for health care workers in calculating tariffs for hospital care beginning in 2019-2020, which could compromise affordable implementation of the reform. The World Bank team will continue to work closely with the authorities to monitor fiscal costs and provide recommendations in the course of implementation.

Prior Action 8: *Enacted Law No. 2168-VIII “On Public Financial Guarantees of Health Care for the Population” dated October 19, 2017 to transform the financing of health care by: (i) shifting from in-patient curative to preventive health care and from input-based to output-based financing; and (ii) putting in place a new transparent health benefit package.*

Expected Results: Share of health spending on primary care increases from 12 percent in 2016 to 15 percent in 2019. Share of adult men receiving CVD drugs reimbursed by the government increases from 0 percent in 2016 to 4 percent in 2019.

45. **The prior actions supported by the PBG are based on thorough analytical and advisory work.** The key pieces of analytical work and technical assistance, carried out by the World Bank Group, and other development partners such as the IMF, EU, and OECD, are summarized in Table 4 below.

Table 4. PBG Prior Actions and Analytical Underpinnings

Prior actions	Analytical Underpinnings
Pillar 1: Strengthen Factor Markets and Institutions	
Prior action 1: State-Owned Banks	WB Financial Sector Technical Assistance (2017-2018)
Prior action 2: Non-Performing Loans	WB, “Assessment of NPL resolution framework in Ukraine” (2017); World Bank Financial Sector Technical Assistance (2017-2018)
Prior action 3: Land markets	WB ASA, “Supporting transparent land governance in Ukraine” (2017); Kyiv School of Economics, “Restrictions on farmland sales markets: a survey of international experience and lessons for Ukraine” (2016); WB, “Special Focus Note on Reforming land markets for agricultural growth” (2017)
Prior action 4: Anti-Corruption Court	Council of Europe, Venice Commission, “Ukraine – Opinion on Draft Law on Anti-Corruption Courts” (2017); OECD, “Anti-Corruption Reforms in Ukraine” (2017); WB Technical Assistance on Anticorruption (2017-2018).
Pillar 2: Promote Fiscally Sustainable and Effective Services	
Prior action 5: Pensions	WB “Public Finance Review” (2017), WB “Public Finance Review 2” (2018); WB Technical Assistance on Pensions (2017-2018)

Prior action 6: Housing Utility Subsidies	WB “Public Finance Review” (2017), WB “Public Finance Review 2” (2018); WB Technical Assistance on Energy Sector (2017-2018).
Prior action 7: Energy-Efficiency Fund	WB/IFC Technical Assistance on “Establishment of Energy Efficiency Fund” (2017-2018).
Prior action 8: Health	WB “Public Finance Review” (2017), WB “Public Finance Review 2” (2018); WB Health Project (ongoing).

3.2 Link to CPF, Other Bank Operations, and the WBG Strategy

46. **The proposed PBG is closely aligned with the objectives of the Ukraine Country Partnership Framework (CPF) for FY17-21.** The objective of the CPF (Report # 114516-UA discussed at the Board on June 20, 2017) is to promote sustained and inclusive economic recovery through a program focusing on four areas including: (i) better governance, anticorruption, and citizen engagement; (ii) making markets work; (iii) fiscal and financial sustainability; and (iv) efficient, effective, and inclusive service delivery. The proposed PBG is a central component of the CPF’s strategy to prioritize support for critical reforms. The CPF recognizes that the achievement of results will depend on reforms that face opposition from vested interests and thus require deep engagement by the Government and other stakeholders. The reforms supported by the PBG are closely tied to the priorities identified in the 2017 Ukraine Systematic Country Diagnostic on “Toward Sustainable Recovery and Shared Prosperity”. The SCD provides the analytical underpinnings for many of the reform areas supported by the PBG. The reform areas supported by the PBG are also closely aligned with World Bank investment projects in social assistance and health, and with World Bank technical assistance in the financial sector, land markets, anticorruption, and pensions.

3.3 Consultations, Collaboration with Development Partners

47. **The authorities have carried out extensive consultations with stakeholders on the reforms supported by this proposed operation.** The reforms supported by this operation are consistent with the Government’s program issued in May 2016 and the medium-term action plan for 2017-2020 approved by the Cabinet of Ministers in April 2017, which were discussed with civil society, development partners, and the public through various channels. More specific consultations have been held on the different reform areas. On land reform, this has included a working group with representatives from the private sector and development partners. It has also included a government communications campaign supported by USAID and the World Bank. On pension and health reform, the authorities have undertaken significant consultations and public outreach with the public, development partners, parliament, and civil society. On the High Anti-Corruption Court, extensive discussions and debate including government, members of parliament, and civil society representatives have taken place in the media. On the State-Owned Bank Law, discussions have taken place with banking sector representatives and the private sector. Across various reform areas, government representatives have appeared on media programs to explain the rationale, design, and outcomes of the reforms.

48. **Collaboration among development partners has been a cornerstone in the effort to support policy reforms in Ukraine.** The World Bank has coordinated the PBG’s support for reforms closely with the IMF, the European Union/Commission, the European Bank for Reconstruction and Development (EBRD), the United States/USAID, UK/DFID, Switzerland, Canada, Sweden, and other development partners. In addition to collaboration with international development partners, the World Bank’s support for

policy reforms has also collaborated closely at the national and subnational level with the private sector, academia, and civil society to organizations to ensure knowledge sharing and coordination of efforts.

V. OTHER DESIGN AND APPRAISAL ISSUES

4.1 Poverty and Social Impact

49. The policies supported by this PBG are expected to have a positive or neutral gender, poverty and social impacts, particularly over the medium and long term. Some of the actions aimed at boosting growth prospects, particularly those aimed at strengthening the financial sector, business environment, and anticorruption institutions are not expected to have any significant direct distributional effects. The impacts of these actions on households and especially the poorest are likely to be through expected higher and more sustainable growth rates. The other actions supported by the operation, including reforms to land markets, the HUS program, and pension and health systems could potentially have large direct distributional effects and are discussed further below.

50. The measures supporting improved transparency and security of land rights are expected to have an overall positive distributional effect in the medium term. This is because the reform could help improve incomes for 4.5 million small landowners who often rent out their land for a fraction of its economic return, and for whom land rights are often undermined by weaknesses in the cadastre and registry. If the measures lead to the establishment of an agriculture land market going forward, the distributional impact would likely be greater. Small landowners would also benefit from improved access to credit from the use of land as collateral. In particular, analysis of the impact of the opening of land markets, higher land rents, and improved credit access (using information obtained from a recent USAID Agroinvest survey) suggests that with lifting of the moratorium, 38 percent of the economic return of land would go to landowners compared to an estimated 14 percent under the current situation. The survey suggests that currently landowners are older workers or retired, with 53 percent reporting being able to cover food expenditures but not other basic needs such as clothes. With rental incomes currently estimated at 20 percent of their income, the lifting of the moratorium together with improvements in transparency would significantly improve their livelihoods.

51. The prior action to improve the targeting and fiscal sustainability of HUS is expected to enhance the progressive nature of the program. The reform is expected to preserve the program's ability to protect lower income groups, although negative impacts on some small groups of current beneficiaries cannot be ruled out. A number of parametric and administrative changes have been made to improve the targeting of the HUS, enhance income reporting and verification, and make the program more responsive to current economic conditions. Among these, the main impact on lower income households can be expected to be through the changes to the HUS allowance and the introduction of a mandatory monthly minimum payment. Simulations of the impact of the allowance reduction indicate that the coverage of the bottom 40 percent of the population would remain essentially flat (a small 0.5 percent decline), while the coverage of the top of the distribution would decline 3.4 percent. In addition, the average payment received by top 60 percent of households would decline by 17 percent (compared to 12 percent for all households). As a result, the decrease in the allowance is simulated to result in a 1-1.5 percentage points increase in the share of resources going to the bottom 40 percent. Such impact should be enhanced by additional measures to improve income reporting and verification. As for the mandatory minimum payment, a small share of beneficiaries can be

expected to be affected⁷. Since the share of the minimum payment decreases with lower incomes, impacts on lower income groups can be expected to be minimal. The other steps supported by this prior action to make the HUS program more responsive to current incomes should help shrink the program due to income growth of formal wage earners and pensioners, without affecting the program's ability to cushion negative impacts on the most vulnerable. Simulations of the impacts of the recent and planned gas and heating tariff increases show that the average energy share of household budgets is estimated to rise but on average remain below the commonly accepted 10 percent threshold used to identify energy poverty. In these scenarios, the HUS is expected to expand through increased average benefits for the bottom 40, while coverage would remain virtually unchanged, compared to the baseline with no tariff increase.

52. The prior action to establish the EEF is expected to have no negative impacts on lower income groups, while being potentially beneficial to poor recipients. Improvements in energy efficiency are an important component of improving energy affordability for lower income households. Significant variation exists in the utility budget shares across income groups. Despite an average budget share of 5 percent among the B40, almost a quarter of that group faces budget shares at least twice as high. Improvements in energy efficiency should, therefore, have a significant beneficial impact on poor recipients. If the selection of buildings is done in a way that targets lower income groups, the impact on the poor would be even greater.

53. Pension reform can be expected to benefit some of the poorest pensioners, a group composed of 65 percent of women. In 2014, before the pension freeze, only 10 percent of pensioners were in the bottom quintile and 29 percent were in the B40. With pension benefits declining sharply in real terms in 2014-2016 (due to the nominal freeze in the face of high inflation), the relative position of pensioners in the income distribution fell, with 15 percent of them in the bottom quintile and 33 percent in the B40 in 2016. The increase of pensions under the current reform can therefore be expected to impact positively a group which was downwardly mobile, and be particularly beneficial for the pensioners in the bottom quintiles. Thus, the reform is estimated to have had an overall pro-poor impact.

54. The health reform, particularly the first phase is expected to have the clearest positive distributional impact on poorer groups by strengthening primary care and reimbursable medication programs. According to the most recent data available, households in the bottom 40 percent of the distribution spend about 4 percent of their income on health, against 3.4 percent for top 60 percent. As the reform leaves flexibility in the definition of the defined guaranteed package for which hospitals would be contracted, and as there is no direct information on which services are accessible to poorer groups in society, it is not possible at this stage to estimate the distributional impacts of this second phase.

55. Among the pressing gender equality challenges facing Ukraine, a major gender gap in life expectancy is being addressed by the proposed PBG. Ukrainian men have an average life expectancy that is 9 years lower than for women (68 years for men and 77 years for women in 2017). Studies have shown that the leading cause of high male mortality in Ukraine is *unmanaged* Non-Communicable Diseases (NCD), particularly cardio-vascular diseases (CVD), as well as injuries and alcohol and tobacco consumption. One of the main reasons for poor management of NCD and CVD among men is the weak primary care system and the lack of access to CVD drugs. In this context, the PBG prior action on reforming the health system is expected to help address this gender gap by: (i) strengthening the primary care system; and (ii) increasing the availability of CVD drugs for men. Specifically, by strengthening the primary health care system and raising the share of CVD drugs reimbursed by the state from 0 percent in 2016 to 4 percent in 2019, the

⁷ The analysis of a sample of administrative data shared by the Ministry of Social Policy suggests that no more than 20 percent of beneficiaries would be affected.

reform would help to strengthen *management* of CVD among men, tackle one of the main drivers behind high male mortality (NCD and CVD), and thus help close the gender gap in life expectancy going forward.

56. The proposed PBG is also associated with broader gender related benefits through the health and pension reforms. More broadly, both men and women face poverty and vulnerability risks associated with high out of pocket payments for health services. The health reform will help address gender-disaggregated primary health care challenges faced by both men and women and mitigate vulnerability for both along these dimensions. For example, the reform will also help to increase availability of drugs for prevention of postnatal haemorrhage for women. Women also face vulnerability risks from weaknesses in the sustainability and adequacy of pension benefits. More than 70 percent of pensioners are women, primarily due to higher female life expectancy. In this context, the PBG prior action on strengthening the fiscal sustainability and adequacy of the pension system addresses a major vulnerability facing women. Ukraine has high educational attainment and labor force participation for women, and progress has also been made in reducing maternal and infant mortality and improving prenatal care and mother-to-child transmission of HIV. However, women are employed disproportionately in public administration, education, healthcare, and social service, and can face barriers in other sectors where the extensive system of social protection on maternity can lead to a bias.

4.2 Environmental Aspects

57. The proposed operation promotes climate and environmental benefits in the most important areas of climate related challenges for Ukraine, including the vulnerability of the large agricultural sector to higher temperatures and the highly energy intensive residential infrastructure. Three out of eight prior actions supported by the operation promote environmental and climate benefits in these areas. First, the prior action in land markets strengthens the transparency, accuracy, and security of land rights, and thus provides an incentive for landowners and land users to more sustainably manage land assets, undertake investments to manage climate impacts, and avoid deforestation. Second, the prior action to improve targeting of housing utility subsidies provides a fiscally and socially sustainable route for Ukraine to sustain the large adjustments of energy tariffs of recent years, which is critical to provide incentives to improve the energy efficiency of residential infrastructure. Third, the prior action on the energy efficiency fund establishes an instrument to address key bottlenecks and provide resources for energy efficiency investments in residential infrastructure.

58. Climate benefits of the land markets prior action. Ukraine is one of the largest agricultural producers in the world and a significant portion of the population relies on the agriculture sector for livelihood. However, climate related challenges threaten this major source of economic growth and household incomes. Higher temperatures could cause shifts in agricultural zones across Ukraine, and floods and water deficiencies have had a significant impact on agricultural output and household incomes over the last 20 years. An exacerbation of these vulnerabilities could undermine Ukraine's overall development objectives, as well as the objectives of this operation. By undermining incentives to sustainably manage land and undertake mitigating investments, the insecurity of land rights leaves Ukraine's agricultural sector and associated household livelihoods even more vulnerable to climate change. This prior action to strengthen the transparency, accuracy, and security of land rights is thus central to providing better incentives for landowners and land users to sustainably manage land, undertake investments in mitigating the impact of climate impacts, and reduce deforestation. This prior action thus has both climate change mitigation and adaptation benefits.

59. Climate benefits of the HUS prior action. Ukraine is ranked fifth in the world for energy intensity and is also one of Europe's largest energy consumers. One of the major sources of this extraordinary energy

intensity is energy prices that historically were maintained at extraordinary low levels. This led to the development of energy inefficient infrastructure in the residential, industrial, and agriculture sectors. In 2015 and 2016, the authorities embarked upon a historic energy tariff adjustment program which raised heating and gas tariffs between 250 to 500 percent, thus essentially eliminating a massive quasi-fiscal transfer to the energy sector (about 6 percent of GDP in 2014). The only way of making this extraordinary energy tariff adjustment socially and politically acceptable was to also scale up and subsequently target the HUS program (designed to limit the share of a household's expenditures on energy). This prior action on improving targeting of the HUS program is thus critical in sustaining the extraordinarily large energy tariff adjustments, and providing incentives to improve the energy efficiency in Ukraine. This energy tariff policy is the cornerstone of improving energy efficiency in Ukraine. In fact, the successive adjustments in energy tariffs and the HUS have progressively incentivized greater energy efficiency in the residential sector. In 2017, Ukraine's total natural gas consumption has decreased by 4 percent compared to 2016 (from 33.2 to 31.9 bcm). Out of this total, household consumers used 11.2 bcm of gas in 2017, which is 6 percent or 0.7 bcm less than in 2016. The reduction in gas used to generate heat for households, through district heating was even larger. Without this prior action, the massive adjustment in Ukraine's energy tariff policy, along with the associated incentives for improving energy efficiency, would unravel.

60. Climate benefits of the EEF prior action: Ukraine's residential infrastructure is one of the greatest sources of energy inefficiency. This is because of historically low energy prices. While the marked rise in energy prices provides a significant incentive to undertake energy efficiency investments, these are constrained by the lack of financing, as well as a host of regulatory barriers and market failures. This prior action on the EEF addresses these regulatory and market failures and creates an instrument to address the financing constraints. This is thus a critical component of improving energy efficiency in Ukraine, and in meeting and potentially exceeding Ukraine's commitments under the Paris Agreement. In February 2018, Ukraine announced that it would reduce emissions by 66–69 percent below 1990 levels. This target would be far more ambitious than Ukraine's current commitment under the Paris Agreement, which includes a target of reducing GHG emissions, including land use, land use change and forestry (LULUCF) by at least 40 percent below 1990 levels by 2030.

4.3 PFM, Disbursement, and Auditing Aspects

61. While the PFM system is reliable, the government is committed to strengthen it further. The latest available Public Expenditure and Financial accountability (PEFA) assessment for Ukraine was undertaken in 2015. It concluded that Ukraine continues to have in place fundamental systems of public financial management. Reforms supported by the previous Multisectoral DPLs in 2014-2015 helped Ukraine improve the PFM system by: establishing a multi-year budgeting framework; revamping intergovernmental transfers; improving data disclosure on tax arrears; introducing transfer pricing controls; strengthening public procurement and public investment management systems; and abolishing a target driven approach to revenue collection. The government is committed to further enhance the system. The Public Administration Reform and the PFM Reform Strategy were approved in December 2016 and March 2017, respectively. These aim to address challenges in medium-term budgeting, budget execution, payroll and headcount systems for the public sector (including the creation of an Human Resource Management Information System with the support of the World Bank and the EU). Since 2015, Ukraine has made some progress in improving fiscal accounting (including introducing a common chart of accounts for all government units in 2017), but further efforts are needed to strengthen financial information systems. The recently adopted Public Sector Accounting strategy for the period of 2018-2025 should help to continue modernize accounting standards and increase transparency of reporting. The Government also continues to improve transparency in public procurement, including through the ProZorro system.

62. **Ukraine continues to maintain several foreign exchange restrictions, but the recently adopted currency regulation reform will gradually phase them out.** The exchange restrictions in Ukraine were put in place during the crisis and helped to stabilize the currency market. Some of the measures were removed after the situation improved, but the remaining restrictions are: (i) absolute limits on the availability of foreign exchange for certain non-trade current international transactions; and (ii) a partial ban on the transfer abroad of dividends received by nonresident investors from foreign investments in Ukraine. In June 2018, the Law on Currency and Currency Operations was approved to prescribe that currency restrictions will be lifted gradually under favorable macroeconomic conditions, which should help ensure price and financial stability and a favorable business environment.

63. **The most recent audit report on the consolidated financial statements of the NBU for the financial year ending December 31, 2017 provided an unqualified audit opinion.** According to auditor's report, NBU consolidated financial statements (consisting of the consolidated statements of financial position, comprehensive income, change in equity, and cash flows) are made in accordance with the IFRS and present fairly the financial position of the National Bank of Ukraine.

64. **The Single Treasury Account is held at the NBU and operated in a reliable environment.** No additional fiduciary arrangements including audit are required for the operation, given the progress in public financial management reforms. The 2015 PEFA scored the effectiveness of expenditure commitment control at the highest level. The PEFA noted that the Treasury system, applied across government at all levels, includes a module whereby commitments should be registered before orders are placed or contracts concluded, and will only be accepted if they are within the budgetary provision of the spending unit. Under this system, commitments cannot extend beyond the current budget year, and if not already provided would require authorization or new appropriations.

65. **Overall Conclusion.** The public financial management systems, together with the Borrower's commitment to reform, are adequate to support this operation.

4.4 Monitoring, Evaluation, and Accountability

66. **The Ministry of Finance (MoF) is responsible for the overall coordination of the proposed operation.** While the MoF is the primary coordinating counterpart, some of the line ministries are responsible for implementation in their respective areas. The Ministry of Agriculture and the Ministry of Justice have the responsibility for implementing the land reform, the Ministry of Finance in coordination with the National Bank of Ukraine has the responsibility for implementing the banking sector reforms, the Judicial Council has the responsibility for implementing the High Anti-Corruption Court, the Ministry of Social Policy has the responsibility for implementing the HUS and pension reforms, and the Ministry of Health has the responsibility for implementing the health reform.

67. **The specific expected results indicators, set out in Annex 1, will be used to monitor implementation of the operation.** The Bank, in collaboration with the Ukrainian authorities, will monitor and evaluate the program's achievement of these results.

68. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which

determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit <http://www.worldbank.org/GRS>. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

VI. SUMMARY OF RISKS AND MITIGATION

69. **The overall risk to the proposed operation is high.** The risks to the proposed PBG have been assessed using the Standardized Operations Risk-rating Tool (SORT), as summarized in Table 5. The main risks to the proposed operation that are rated High include political (including security) and governance risks; and macroeconomic risks, while sector policies and implementation risks are rated Substantial.

Table 5: Summary of Risk Ratings

Political and governance	High
Macroeconomic	High
Sector strategies and policies	Substantial
Technical design of project or program	Moderate
Institutional capacity for implementation and sustainability	Substantial
Fiduciary	Moderate
Environment and social	Moderate
Stakeholders	Moderate
Overall	High

70. **Political and governance:** Parliamentary and presidential elections are scheduled for 2019, and the political environment remains complex, uncertain, and influenced by vested interests. These are major impediments to advancing reforms, and could also lead to reversals in important areas. Mitigating factors include an increasingly proactive civil society demanding reform and change following the Euromaidan revolution of 2014, as well as the close engagement of the international community to advocate jointly for the most critical reforms. Ukraine also faces the risk of intensified conflict between armed groups and government forces in eastern Ukraine, which would adversely impact economic prospects through weaker investor confidence and increased military spending. These conflict related risks are amplified and mitigated by geopolitical considerations, where developments in other countries could affect the degree of conflict in Ukraine or the extent of international support for the resolution of the conflict.

71. **Macroeconomic:** Ukraine faces considerable macroeconomic risks which would be compounded if the political and security risks were to materialize. While Ukraine has made progress in restoring macroeconomic stability in the last three years, fiscal and external vulnerabilities are significant. The growth outlook remains weak; public and external debt remain high; and Ukraine faces large financing needs in 2018-2019, together with expenditure pressures from higher public-sector wages and spending on social programs. The 2019 elections could exacerbate the expenditure pressures and make it more difficult to secure the necessary financing from international capital markets. Moreover, the financing environment for emerging markets has deteriorated in 2018. If reforms to bolster investor confidence and address fiscal pressures do not progress, the financing needs would be difficult to meet, and the growth outlook would deteriorate further, which would threaten fiscal and external sustainability and macroeconomic stability more generally. The proposed operation contributes to mitigating the macroeconomic risks through reforms to

both bolster investor confidence and also address expenditure pressures. The authorities close engagement with the World Bank and IMF on reviewing the macroeconomic policy framework, as well as in design and implementing key reform measures is important in mitigating macroeconomic risks.

72. Implementation risks (including sector policies and institutional capacity). Many of the reforms supported by the proposed PBG are ambitious and require strong capacity for implementation and monitoring. Several reforms will also require some time to become fully effective. Examples include the establishment of the High Anti-Corruption Court which will require successful selection of independent judges with the support of the expert panel; the State-Owned Banking Law, which will require successful selection of independent supervisory boards; and the health reform which will require successful rollout of primary care as well as development of a hospital sector plan. Implementation could be undermined by a number of factors including weaknesses in institutional capacity, delays in decision making, and opposition from vested interests particularly during an election year. These risks are mitigated in part by technical assistance provided by development partners and by close engagement of civil society organization to resist vested interests.

ANNEX I. POLICY AND RESULTS MATRIX

Objectives	Prior Actions	Results
PILLAR 1: STRENGTHEN FACTOR MARKETS AND INSTITUTIONS		
Strengthen corporate governance of state-owned banks	<u>Prior Action 1</u> : Enacted Law No. 2491-VIII “On Improving the Functioning of the Financial Sector” dated July 5, 2018 to establish independent supervisory boards and strengthen risk management at State Owned Banks (SOBs); and adopted a strategy for the development of SOBs which establishes a roadmap for gradual divestiture.	Number of SOB supervisory boards with at least two-thirds of independent board members Baseline (end-2016): 1 Target (2019): 4
Strengthen the resolution framework for non-performing loans (NPLs)	<u>Prior Action 2</u> : Enacted Law No. 2245-VIII “On Amendments to the Tax Code” dated December 7, 2017 to remove the 25 percent ceiling for provisioning expenses and issued orders on the tax treatment of transactions involving nonperforming loans; and enacted Law No. 2478-VIII “On Resumption of Lending” dated July 3, 2018 to increase creditors’ rights.	
Create the conditions to establish a transparent market for agricultural land transactions	<u>Prior Action 3</u> : Strengthened the transparency of agriculture land records by: (i) integrating the cadaster and the registry data; (ii) approving Cabinet Decision No. 31 dated August 22, 2018 to commit to the registration of all state agricultural land by December 2020; and (iii) establishing a land governance monitoring system including rental and sales prices.	Amount of registered state land Baseline (2016): 1 million hectares Targeted (2019): 4 million hectares
Strengthen anticorruption institutions	<u>Prior Action 4</u> : Enacted Law No. 2447-VIII “On the High Anti-Corruption Court”, dated June 7, 2018 to establish a specialized High Anti-Corruption Court comprised of independent judges selected in line with the recommendations of the Venice Commission.	Number of cases under review by the High Anti-Corruption Court. Baseline (end-2016): 0 Target (2019): 25

Objectives	Prior Actions	Results
PILLAR 2: PROMOTE FISCALLY SUSTAINABLE AND EFFECTIVE SERVICES		
Enhance adequacy and sustainability of old age pension benefits	<u>Prior Action 5</u> : Enacted Law No. 2148-VIII “On Increase of Pensions” dated October 3, 2017 to improve fiscal sustainability, adequacy of old age benefits, and incentives to contribute by providing incentives to retire later in exchange for higher benefits and preserving the value of benefits over time through systematic indexation.	Average old age pension replacement rate (percent): Baseline (end-2016): 27 Target (2019): 30 Pension expenditures (share of GDP, percent): Baseline (2016): 10.7 Target (2019): About 10.5
Improve targeting and fiscal sustainability of the housing and utilities subsidy (HUS) program	<u>Prior Action 6</u> : Improved the Housing Utility Subsidy (HUS) program by: (i) revising social norms and parameters of the formula and introducing additional means-testing mechanisms; and (ii) monetizing the HUS settlement at the level of gas and heating utilities, as evidenced by Cabinet Resolution No. 329 dated April 27, 2018 and Cabinet Resolution No. 951 dated November 8, 2017.	Share of HUS spending going to B40 population: Baseline (end-2016): 46 percent Target (2019): 50 percent
Establish an energy efficiency fund	<u>Prior Action 7</u> : Adopted the charter of the Energy Efficiency Fund (EEF), including procedures for using budget funds for the operation of the EEF, as evidenced by Cabinet Resolution # 1099 dated December 20, 2017.	Baseline (2016): EEF not operational Target (2019): EEF becomes operational and initiates the provision of resources for building retrofits in 2019

Objectives	Prior Actions	Results
Transform financing of health care	<p><u>Prior Action 8</u>: Enacted Law No. 2168-VIII “On Public Financial Guarantees of Health Care for the Population” dated October 19, 2017 to transform the financing of health care by: (i) shifting from in-patient curative to preventive health care and from input-based to output-based financing; and (ii) putting in place a new transparent health benefit package.</p>	<p>Share of health spending on primary care Baseline (2016): 12 percent Target (2019): 15 percent</p> <p>Share of adult men receiving CVD drugs reimbursed by the government Baseline (2016): 0 percent Target (2019): 4 percent</p>

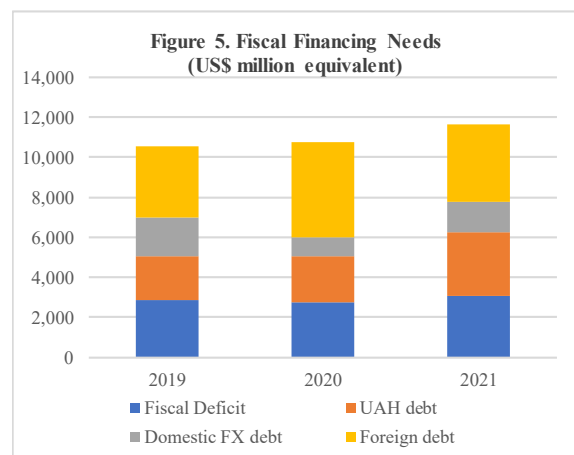
ANNEX II: GUARANTEE RATIONALE AND INDICATIVE TERM SHEET

1. **The Government of Ukraine has requested IBRD support in the form of a Policy-Based Guarantee (PBG) to enhance a significant market borrowing.** This PBG of US\$ 750 million equivalent is intended to be used to raise about US\$ 1 billion equivalent, for the purpose of helping Ukraine finance its budget and public debt repayment. This outcome would represent a well-leveraged transaction and would align with IBRD's broader objective to leverage its balance sheet and increase risk-sharing with private partners. To avoid interfering with efforts to place Eurobonds and to diversify sources of financing, the Government intends to use the PBG to support a private transaction in the lending market to complement any separate potential public transactions in the Eurobond market.

2. **The proposed PBG would help Ukraine obtain financing at a sustainable cost and an attractive maturity, by catalyzing lower cost financing and a longer maturity than is currently available on a standalone basis.** Market soundings indicate that Ukraine's unguaranteed access to private syndicated loans from banks, insurance companies, and institutional funds is limited. Lenders today have limited appetite to provide scaled budget financing to Ukraine at reasonable maturities and manageable costs without some form of guarantee or credit enhancement. However, the soundings indicate that the presence of IBRD, through its AAA coverage of a share of the transaction and its partnership role in the transaction, can improve terms for Ukraine in meaningful ways. An IBRD guarantee of \$750 million equivalent should allow Ukraine to mobilize about \$1 billion equivalent, with maturity of 10 years. Notional cost savings may be in the order of 200bp per annum or more, and a competitive process could lead to even greater cost reduction.

3. **The Government of Ukraine intends to use the PBG to support a private transaction in the lending market, rather than a public transaction in the Eurobond market.** The estimated size of the transaction is considered large but manageable in the private lending market. A hypothetical guaranteed transaction in the Eurobond market would be inefficient due to weak demand in the liquid emerging market bond investor base for non-standard or hybrid instruments and difficulty with pricing and trading of such an asset. Bank markets present their own challenges, including funding cost considerations for lending institutions, internal balance sheet charges, return requirements, reduced scalability, etc., all of which also may undermine efficiency. Yet, the expected benefits are considered higher in the loan market for this borrower, at this juncture in time than in the bond market.

4. **The PBG aims to mobilize a market loan that amortizes principal repayments and/or partially clears the debt hurdle faced by the Government between 2019-2021.** Ukraine requires significant financing of \$11 billion (8 percent of GDP) in 2019 to repay public debt and cover the fiscal deficit (Figure 5). The government plans to raise about \$4.2 billion from external sources (including Eurobonds and international financial institutions), with the remainder from domestic borrowing in local and foreign currency. In addition to this IBRD-guaranteed transaction, the government expects to raise additional Eurobonds and receive Euro 1 billion from the European Union Macro-Financial Assistance (MFA). To ensure a manageable repayment profile and to address roll-over risks stemming from external debt in the next five years, the Government seeks to mobilize the PBG-supported funding with maximum possible principal repayments at maturity, and a grace period of at least four years.



5. **The proposed PBG is also expected to help de-risk Ukraine in attracting additional necessary financing from Eurobonds.** Ukraine's access to international capital markets remains constrained due to deteriorating market conditions, as well as macroeconomic vulnerabilities. While Ukraine issued a \$2 billion Eurobond in October 2018 (with a mix of 5-year and 10-year maturity) and 15-year, \$3 billion Eurobond in September 2017, the yield on both has been one of the highest among emerging markets. The recent turbulence in the emerging markets has led to an increase in yields for Ukraine's Eurobonds, with the 10-year issue rising to 9.75 percent. Completing the reforms supported by the proposed PBG and the IMF program would help bolster investor confidence, reduce Ukraine-specific risk, and help Ukraine attract additional financing at more attractive terms. Without this, all the necessary financing would need to be raised from shorter maturity and more expensive domestic and Eurobond markets, including increasing borrowing from state-owned banks and drawing down reserves.

6. **Approval is requested from the IBRD Board of Executive Directors for the proposed PBG operation as per the Indicative Term Sheet (see below).** The Executive Directors will be informed of the final terms and conditions of the PBG supported commercial financing operation after execution, which would follow Board approval of the PBG. If there is any substantial change in the terms and conditions of the PBG, the approval of the Executive Directors will be sought prior to execution.

INDICATIVE TERM SHEET OF PROPOSED IBRD POLICY-BASED GUARANTEE

<i>This term sheet contains a preliminary summary of indicative terms and conditions of a proposed guarantee ("Guarantee") by the International Bank for Reconstruction and Development ("IBRD") for discussion purposes only and does not constitute an offer to provide a Guarantee. The provision of a Guarantee is subject, inter alia, to satisfactory appraisal by IBRD of the operation, including completion of all prior actions by Ukraine and the adequacy of its macroeconomic framework, compliance with all applicable policies of the World Bank, including those related to environmental and social safeguards, review and acceptance of the transaction documentation by IBRD, and the approval of the management and Executive Directors of IBRD in their sole discretion. Without limiting the generality of the foregoing, IBRD is highly selective with regard to the clients and beneficiaries it works with and is diligent with Know Your Customer requirements for all participants in financings it guarantees or supports.</i>	
IBRD-Guaranteed Loan (the Financing)	
IBRD-Guaranteed Loan Agreement:	Agreement among the Borrower, the Agent [on behalf of] [and the] Lenders and IBRD as Guarantor setting out terms and conditions of the Financing, mechanism for payment on the Financing, and containing the Guarantee ⁸ .
Borrower:	Ukraine
Guaranteed Lender/Beneficiaries of the IBRD Guarantee:	[Commercial bank lenders, or the Agent on their behalf, each to be identified]
Currency:	EUR and USD
Principal Amount:	[USD 1 billion equivalent]
Term:	[10] years

⁸ Alternatively, the guarantee agreement can be a stand-alone agreement between the Agent [on behalf of] [and the] Lenders and IBRD. In those cases, IBRD will not be a party to the IBRD-Guaranteed Loan Agreement.

Repayment of the Financing:	[Annual]
Loan Interest Rate:	[Spread above EURIBOR or LIBOR acceptable to Borrower and IBRD] or [fixed interest rate acceptable to Borrower and IBRD]
Use of Proceeds:	[Budget financing]
Drawdown:	[Multiple drawdowns possible]
IBRD Guarantee	
Guarantor:	International Bank for Reconstruction and Development (IBRD)
Guarantee Face Value:	[USD 750 million equivalent]
Guarantee Support:	IBRD would guarantee the payment, following occurrence of a Guaranteed Event, of [selected, pre-agreed debt service payments of principal and interest amounts] due on scheduled payment dates up to the Maximum Guaranteed Amount.
Guaranteed Events:	Failure by the Borrower to [make certain payments of [principal] [and interest] on] [repay at scheduled maturity the principal amount of] the IBRD-Guaranteed Loan.
Guarantee Period:	[TBD]
Maximum Guaranteed Amount:	A partial amount of financing, not to exceed the Guarantee Face Value.
Signing:	If the IBRD Guarantee and related legal agreements (including the Indemnity Agreement) are not signed within 12 months following approval by the Board of Executive Directors of IBRD, IBRD may withdraw its offer of the Guarantee.
Amendments and waivers:	IBRD will be entitled to be kept fully informed about any proposed waiver or amendment to the terms of the transaction. Certain amendments or waivers to the provisions of the transaction documents will require the prior written consent of IBRD, including, but not limited to, any material amendment or modification to a finance document or any amendment or waiver that relates to the IBRD Guarantee or affects the rights or obligations of IBRD.
Suspension:	IBRD may, during the availability period for drawdown of the guaranteed financing, inform the Agent that no further drawdown of the guaranteed financing, from the date of notification by IBRD up until such notice is revoked by IBRD, will be covered by the IBRD Guarantee upon the occurrence of the following types of scenarios, inter alia: (i) an event of default occurs under the guaranteed financing; or (ii) Ukraine has ceased or been suspended from its membership of the World Bank or International Monetary Fund; or (iii) the Agent or a beneficiary of the IBRD Guarantee engaged in certain sanctionable practices (fraud, corruption, coercion, collusion, obstruction) relating to the guaranteed financing. If the event giving rise to a suspension has been waived by IBRD, or remedied to IBRD's satisfaction, then IBRD may revoke its suspension notice and let the Agent know which amounts are reinstated for coverage under the IBRD Guarantee. If such suspension continues for a period of [6] months, the IBRD Guarantee will reduce permanently by the amount with respect to which IBRD had suspended coverage.

Exclusion:	IBRD is not liable for losses directly resulting from noncompliance with, or the invalidity, illegality or unenforceability of any transaction document under laws in effect on, or events occurring before, the date of the IBRD-Guaranteed Loan Agreement.
Withholding:	IBRD may withhold payment to a beneficiary of the IBRD Guarantee in the following types of scenarios, inter alia: (i) a sanctionable practice (fraud, corruption, coercion, collusion, obstruction) has been committed by the Agent or a Guaranteed Lender; (ii) the Agent or a Guaranteed Lender, inter alia, amends the financing documents without IBRD's prior written consent, or transfers or assigns all or part of its interest in the Financing to a non-commercial or debarred or sanctioned entity; or (iii) the Agent or a Guaranteed Lender engages in Repackaging Arrangements in respect of the IBRD Guarantee.
Termination:	The IBRD Guarantee may be terminated, inter alia, (i) if an installment of the Guarantee Fee or Standby Fee is not paid when due; (ii) if an amendment, waiver, modification or other change is made or given relating to certain provisions of the finance documentation, IBRD's rights or obligations, or the IBRD Guarantee without IBRD's prior written consent; (iii) following full payment of all guaranteed amounts; (iv) after the final date for payment under the IBRD Guarantee; or (v) solely in respect of any amounts withheld from payment under the IBRD Guarantee as described above, if IBRD has withheld such amounts for a period of [12] months.
No Discharge:	Neither the obligations of IBRD under the IBRD Guarantee nor the rights, powers and remedies conferred upon the Agent with respect to IBRD by the IBRD Guarantee or by applicable law or regulation shall be discharged, impaired or otherwise affected by: (i) any insolvency, moratorium or reorganization of debts of or relating to the borrower; (ii) any of the obligations of the borrower under the financing agreements being or becoming illegal, invalid, unenforceable, void, voidable or ineffective in any respect; (iii) any time or other indulgence being granted to the borrower in respect of its obligations under the financing agreements; or (iv) any other act, event or omission (other than the failure of the Agent to make a timely and duly completed demand under the IBRD Guarantee) which might otherwise operate to discharge, impair or otherwise affect any of the obligations of IBRD under the IBRD Guarantee or any of the rights, powers or remedies conferred on the Agent by the IBRD Guarantee or by applicable law or regulation.
Reduction of Demand:	If, after the Agent has made a demand on IBRD for payment under the IBRD Guarantee, but before IBRD has made payment of the amount so demanded, the Agent receives payment in respect of such amount from the Borrower (or the Agent recovers otherwise than from IBRD) any sum which is applied to the satisfaction of the whole or any part of such amount, the Agent shall promptly notify IBRD of such fact and IBRD's liability under the IBRD Guarantee in respect of such demand shall be reduced by an amount equal to the portion so paid by the Borrower (or so recovered by the Agent) and so applied.

Non-Accelerability of Guarantee:	The IBRD Guarantee cannot be accelerated and become payable prior to the scheduled debt service payment dates under any circumstances, including if the underlying IBRD-Guaranteed Loan is accelerated as a result of a Guaranteed Event. In such instances, the IBRD Guarantee will cover payment of debt service up to the Maximum Guaranteed Amount in accordance with the original payment schedule.
Conditions Precedent to Effectiveness of the IBRD Guarantee:	Usual and customary conditions for financing of this type including but not limited to the following: a) Provision of relevant legal opinions satisfactory to IBRD (including a legal opinion from the appropriate official of Ukraine relating to the Indemnity Agreement); b) Payment in full of the Guarantee Fee, the Front-End Fee and the relevant installment(s) of the Standby Fee and reimbursement of IBRD's external legal expenses; c) Conclusion of an Indemnity Agreement between IBRD and Ukraine, and any other applicable documentation, acceptable to IBRD; and d) Satisfaction of any other conditions precedent under the financing documents.
Subrogation:	If and to the extent IBRD makes any payment under the IBRD Guarantee, IBRD will be subrogated immediately to the extent of such unreimbursed payment to the lenders' rights.
Right to Purchase:	[If IBRD guarantees payment of interest, then upon payment default by the Borrower, IBRD will have the right to purchase all rights, title and interests of the Guaranteed Lenders in the Financing.]
Repackaging Arrangements:	The Agent and Guaranteed Lenders will severally undertake for the benefit of IBRD that, provided the IBRD Guarantee remains in effect, they will not enter into or permit any of their affiliates to enter into any arrangement pursuant to which any security or other similar obligation is created or issued, the economic effect of which is the separation of rights of payment from IBRD under the IBRD Guarantee and of rights of payments from the Borrower under the financing, which is referred to as "Repackaging Arrangements".
Payment of Fees to IBRD:	Payment of fees due to IBRD is the obligation of the Borrower. [However, if the Borrower fails to pay any installment of the fees due to IBRD in full or when due, [the Guaranteed Lenders] can elect to pay the unpaid amount of the fees and seek reimbursement from Borrower.]
Front-end Fee:	25 bps of the Guarantee Face Value.
Standby Fee:	25 bps per annum, charged periodically and applied to that portion of the guaranteed amount that IBRD has contractually committed and for which IBRD does not yet have financial exposure under the IBRD Guarantee. The IBRD standby fee is normally charged semi-annually and accrues sixty (60) days after the date of signing of the agreement providing for IBRD's guarantee. Standby Fee also applies if IBRD limits coverage of the IBRD Guarantee pursuant to any limitation event. The Standby Fee must be paid in advance on regular payment dates.
Guarantee Fee (recurring):	[X] basis points per annum. The IBRD guarantee fee is charged on that portion of the guaranteed amount that IBRD has contractually committed and for which IBRD has financial exposure under the

	IBRD Guarantee. The Guarantee Fee must be paid [in advance semi-annually on regular payment dates] [in a one-time lump sum]. [Where the Guarantee Fee is payable in installments,] The IBRD Guarantee will terminate in the event of nonpayment of any installment of the Guarantee Fee. ⁹
External Legal Costs:	Reimbursement of IBRD external legal counsel expenses by Ukraine.
Governing law:	English law.
Indemnity Agreement	
Parties:	IBRD and Ukraine (the “Member Country”)
Indemnity:	The Member Country will reimburse and indemnify IBRD on demand, or as IBRD may otherwise direct, for all payments under the Guarantee and all losses, damages, costs, and expenses incurred by IBRD relating to or arising from the Guarantee.
Covenants:	Usual and customary covenants included in agreements between member countries and IBRD, as well as undertakings to pay the fees and expenses of IBRD’s external counsels and other advisors in connection with the Loan negotiation.
Remedies:	If the Member Country breaches any of its obligations under the Indemnity Agreement, IBRD may suspend or cancel, in whole or in part, the rights of the Member Country to make withdrawals under any other loan or credit agreement with IBRD, or any IBRD loan to a third party guaranteed by the Member Country, and may declare the outstanding principal and interest of any such loan or credit to be due and payable immediately. A breach by the Member Country under the Indemnity Agreement will not, however, discharge any guarantee obligations of IBRD under the Guarantee.
Governing Law:	The Indemnity Agreement will follow the usual legal regime and include dispute settlement provisions customary for agreements between member countries and IBRD.

⁹ The guarantee fee level is determined by the average life of the guarantee.

ANNEX III: LETTER OF DEVELOPMENT POLICY



CABINET OF MINISTERS OF UKRAINE
МІНІСТЕРСТВО КАБІНЕТУ МІНІСТРІВ УКРАЇНИ

21784/0/2-18 від 15.11.2018

Лист Уряду України стосовно політики розвитку

Вельмишановний пане Кім!

Від імені Уряду України хочу засвідчити нашу глибоку повагу та вдячність Світовому банку та Вам особисто за підтримку у втіленні найбільш важливих реформ, спрямованих на розвиток України. Наша плідна співпраця в рамках запропонованого системного проекту “Гарантія на підтримку державної політики у сфері економічного зростання та фіскально стійких послуг” (далі — проект) допомогла імплементувати ряд історичних реформ. Ми віримо, що такі історичні реформи є ключовими для прискорення економічного зростання, підвищення ефективності соціальних послуг та посилення фіскальної стійкості України в умовах значних економічних викликів.

З моменту безпрецедентних подій, які вплинули на економіку України в 2014—2015 роках, Україна вже показала свою спроможність впроваджувати глибокі структурні реформи, які допомогли стабілізувати економіку та фінансовий сектор, зменшити макроекономічний дисбаланс та пом'якшити наслідки кризи для населення. Після загального 16-відсоткового падіння в 2014—2015 роках економіка зросла на 2,3 відсотка в 2016 році, на 2,5 відсотка — в 2017 році та на 3,5 відсотка — у першій половині 2018 року, а дефіцит сектору загальнодержавного управління знизився з 10 відсотків валового внутрішнього продукту у 2014 році до 2,3 відсотка валового внутрішнього продукту у 2015—2017 роках. У своїй монетарній політиці Національний банк України залишається серйозно налаштованим на досягнення цінової стабільності у середньостроковій перспективі, що вже допомогло зменшити інфляцію із пікового рівня у 61 відсоток у квітні 2015 р. до 9 відсотків у вересні 2018 року. Дефіцит поточного рахунка платіжного балансу скоротився з 9,2 відсотка валового внутрішнього продукту у 2013 році до 2,1 відсотка

**Його Високоповажності
пану Джиму КІМУ**

**Президенту Світового банку
округ Колумбія, Вашингтон**



у 2017 році, а міжнародні резерви України зросли з 13 млрд. доларів США наприкінці 2015 року до 17,2 млрд. доларів США (що еквівалентно трьом місяцям імпорту) станом на кінець серпня 2018 року. Ситуація у банківському секторі стабілізувалася за рахунок покращення нагляду за банками та запровадження системи рекапіталізації та реструктуризації проблемних банків.

Водночас ми цілком усвідомлюємо, з якими проблемами розвитку на сьогодні стикається Україна, і готові рішуче їм протидіяти для забезпечення кращого рівня життя для своїх громадян. Зокрема, ми прагнемо посилити основи для більш міцного та сталого економічного зростання. Ми віримо, що прискорення темпів економічного зростання є головною передумовою зменшення рівня бідності населення, який залишається досить високим після економічної кризи 2014—2015 років. По-друге, ми усвідомлюємо важливість підтримання макроекономічної і фінансової стабільності та забезпечення належного фінансування державного боргу. По-третє, ми маємо рішучі наміри покращити ефективність системи охорони здоров'я, освіти, пенсійного забезпечення та соціальної допомоги, зберігаючи фінансову стабільність.

Наша макроекономічна політика є сильною і підкріплена нашою рішучістю здійснювати реформи та має на меті такі цілі: забезпечення економічного зростання на рівні 3 відсотки у 2019 році та 4 відсотки — у 2020 році за рахунок відновлення довіри інвесторів; утримання дефіциту бюджету на рівні 2,3 відсотка валового внутрішнього продукту у 2019 році та забезпечення поступового зниження державного боргу; підтримання плаваючого валютного курсу та сприяння зростанню експорту та прямих іноземних інвестицій для підтримки зовнішньої стійкості; сприяння зростанню кредитування приватного сектору економіки за рахунок покращення управління в державних банках та зменшенню кількості непрацюючих кредитів. Наша макроекономічна політика підтримана проектом, макрофінансовою допомогою від Європейського Союзу у розмірі 1 млрд. євро та майбутньою 14-місячною програмою Stand-By Міжнародного валютного фонду у сумі 3,9 млрд. доларів США. 19 жовтня 2018 р. ми досягли згоди з МФВ щодо нової програми співпраці та засвідчуємо свої наміри виконати всі попередні заходи, необхідні для ухвалення згаданої програми Радою Директорів МВФ у грудні 2018 року.

Уряд України також рішуче налаштований щодо подальшого впровадження своєї амбіційної програми структурних реформ. Середньостроковий стратегічний план дій уряду на 2017—2020 роки, затверджений Кабінетом Міністрів у квітні 2017 р., ставить на меті завдання “підвищення рівня життя та якості життя шляхом сталого економічного розвитку”. Ми віддані реформам, які є економічно обґрунтовані, технічно досяжні та розроблені для досягнення довготривалого позитивного ефекту. Бюджетна підтримка з боку міжнародних фінансових інституцій залишається дуже важливою для нас



на шляху збереження прогресу в інституційних та системних реформах, які вже розпочато в Україні.

Допомога Світового банку є надзвичайно важливою для успіху нашої амбітної програми реформ. Запропонована Гарантія на підтримку державної політики у сфері економічних зростання та фінансово стійких послуг розроблена з метою підтримки найважливіших заходів нашого порядку денного реформ, спрямованих на створення умов економічного зростання та забезпечення макроекономічної та фінансової стійкості. Ключові реформи, підтримані проектом, повинні допомогти нам реалізувати два основні напрями нашої політики розвитку: зміцнення ринків факторів виробництва та інституцій і сприяння наданню фінансово стійких та ефективних послуг.

Зміцнення ринків факторів виробництва та інституцій

Реформи у фінансовому секторі, у сфері функціонування ринку землі та запобігання корупції мають на меті подолання основних структурних перешкод з метою залучення інвестицій та зростання в державі. Ми рішуче налаштовані покращити управління державними банками та вжити необхідних заходів для розв'язання проблеми непрацюючих кредитів, що уможливило б поступове відновлення кредитування приватного сектору. Ми також готові підвищити прозорість та забезпечити захист земельних прав, необхідних для створення передумов для побудови ринку землі сільськогосподарського призначення, що повинно стимулювати притік інвестицій та підвищення продуктивності. Також ми рішуче налаштовані на посилення антикорупційних реформ для розв'язання проблем інвесторів з приводу відсутності рівних умов та сприяння. Очікується, що з часом ці реформи допоможуть Україні посилити впевненість інвесторів та переорієнтуватись від залежності від експорту сировинних товарів до збільшення експорту товарів з високою доданою вартістю, інтегрованого до європейський та міжнародних виробничих ланцюгів. З метою досягнення поставлених цілей ми вже вжили ряд конкретних і амбітних реформаторських заходів.

Ми ухвалили та ввели в дію Закон України від 5 липня 2018 р. № 2491-VIII "Про внесення змін до деяких законодавчих актів України щодо удосконалення функціонування фінансового сектору в Україні" щодо утворення незалежних наглядових рад та посилення систем управління ризиками у державних банках та банках із державною часткою в статутному капіталі 75 відсотків і вище; схвалили стратегію розвитку державних банків та банків із державною часткою в статутному капіталі 75 відсотків і вище, яка містить дорожню карту для поступового відчуження. Ми збираємося повною мірою запроваджувати заходи, передбачені згаданим Законом у 2019 році для збільшення кількості наглядових рад державних банків та банків із державною часткою у статутному капіталі 75 відсотків і вище із принаймні двома третинами незалежних членів з одного у 2016 році до чотирьох у 2019 році.



Ми ухвалили та ввели в дію Закон України від 7 грудня 2017 р. № 2245-VIII “Про внесення змін до Податкового кодексу України та деяких законодавчих актів України щодо забезпечення збалансованості бюджетних надходжень у 2018 році” з метою зняття 25-відсоткового граничного розміру витрат на утворення резервів та надали роз’яснення стосовно оподаткування транзакцій, пов’язаних непрацюючими кредитами; ми також ухвалили та ввели в дію Закон України від 3 липня 2018 р. № 2478-VIII “Про внесення змін до деяких законодавчих актів України щодо відновлення кредитування”.

Ми підвищили прозорість у сфері реєстрації земель сільськогосподарського призначення шляхом: інтеграції даних кадастру та реєстру; виконання зобов’язань стосовно реєстрації всіх державних земель сільськогосподарського призначення до грудня 2020 року, ухваливши рішенням Кабінету Міністрів (протокол від 22 серпня 2018 р. № 31); встановлення системи і моніторингу управління земельними ресурсами, включаючи ціни за оренду та продаж. Ми підтверджуємо свою готовність повністю впровадити зазначені заходи для збільшення кількості зареєстрованих державних земель з 1 млн. гектарів у 2016 році до 4 млн. гектарів у 2019 році.

Ми ухвалили та ввели в дію Закон України від 7 червня 2018 р. № 2447-VIII “Про Вищий антикорупційний суд” з метою створення спеціалізованого Вищого антикорупційного суду, який складатиметься з незалежних суддів, обраних відповідно до рекомендацій Венеціанської комісії. Ми підтверджуємо свою готовність підтримувати реалізацію цієї реформи щодо функціонування Вищого антикорупційного суду та розгляд ним щонайменше 25 справ протягом 2019 року.

Сприяння наданню фіскально стійких та ефективних послуг

Реформи, що входять до другого пакета, у сфері пенсійного забезпечення, житлово-комунальних субсидій, запуску Фонду енергоефективності та охорони здоров’я спрямовані на підвищення ефективності цих критично важливих державних послуг та забезпечення соціальних виплат у таких спосіб, щоб одночасно зменшити значне фіскальне навантаження на державний бюджет. Зокрема, ми плануємо продовжувати забезпечувати соціальну справедливість у питанні виплат пенсій за віком шляхом посилення стимулів для участі у пенсійній системі за рахунок більш прозорого зв’язку між внесками та пенсіями. Ми плануємо підвищувати адресність та доступність участі у програмі субсидій на житлово-комунальні послуги. Також ми зобов’язуємось створити Фонд енергоефективності. Ми маємо намір трансформувати систему фінансування охорони здоров’я. З метою реалізації зазначених цілей ми вже здійснили ряд необхідних заходів.

Ми ухвалили та ввели в дію Закон України від 3 жовтня 2017 р. № 2148-VIII “Про внесення змін до деяких законодавчих актів України



щодо підвищення пенсій”, який посилює фінансову стійкість, забезпечує соціальну справедливість у питанні виплат пенсій за віком шляхом посилення стимулів пізнішого виходу на пенсію та за рахунок збільшення розміру виплати по виходу на пенсію, а також збереження рівня пенсійного забезпечення шляхом системної індексації. Ми будемо впроваджувати цю реформу і очікуємо збільшення коефіцієнту заміщення з 27 відсотків у 2016 році до 30 відсотків у 2019 році, оскільки повинні зберегти рівень видатків на рівні 10,5 відсотка валового внутрішнього продукту у 2016—2019 роках.

Ми покращили програму житлово-комунальних субсидій шляхом: перегляду соціальних норм та параметрів формули та впровадження додаткових механізмів перевірки майнового стану; монетизації розрахунків за житлово-комунальні субсидії на рівні постачальників послуг шляхом ухвалення постанов Кабінету Міністрів від 27 квітня 2018 р. № 329 та від 8 листопада 2017 р. № 951. Ми готові і надалі посилювати заходи з метою збільшення частки житлово-комунальних субсидій, яка охоплює найбідніші 40 відсотків населення: з 46 відсотків у 2016 році до 50 відсотків у 2019 році.

Ми ухвалили Статут державної установи “Фонд енергоефективності” та процедури використання коштів для функціонування Фонду енергоефективності шляхом ухвалення постанов Кабінету Міністрів України від 20 грудня 2017 р. № 1099 та № 1102. Ми наголошуємо на нашій готовності забезпечити початок функціонування Фонду, що передбачатиме надання ресурсів для модернізації будівель вже у 2019 році.

Ми ухвалили та ввели в дію Закон України від 19 жовтня 2017 р. № 2168-VIII “Про державні фінансові гарантії медичного обслуговування населення” з метою трансформації фінансування охорони здоров’я шляхом (і) переходу від стаціонарного лікування до профілактичної охорони здоров’я; та переходу від фінансування на основі розрахунків до фінансування на основі результатів; і (ii) запровадження нового прозорого пакета медичних послуг. Ми продовжуємо впроваджувати заходи, спрямовані на збільшення частки витрат на первинну медичну допомогу з 12 відсотків у 2016 році до 15 відсотків у 2019 році.

Мені хотілося також скористатися нагодою запевнити Вас у наших рішучих намірах дотримуватися принципів прозорості та підзвітності у сфері управління державними фінансами та співпраці з міжнародними донорами. Протягом останніх років ми успішно впроваджували реформи, спрямовані на вдосконалення середньострокового бюджетного планування, підвищення прозорості міжбюджетних трансфертів та покращення системи державних закупівель і інвестиційного менеджменту у державному секторі. Ми плануємо і надалі дотримуватися принципів повної підзвітності та прозорості, у тому числі щодо всієї донорської підтримки.



Ми тісно і плідно співпрацювали з нашими колегами із Світового банку під час розроблення програми реформ, підтриманої проектом, і плануємо і надалі разом контролювати виконання програми реформ. Протягом наступного року ми налаштовані сприяти структурній трансформації країни, забезпечуючи якісний рівень реалізації реформ для досягнення озвучених цілей розвитку.

З повагою

Прем'єр Міністр України



Володимир ГРОЙСМАН



LETTER OF DEVELOPMENT POLICY
[UNOFFICIAL TRANSLATION]

Mr. Jim Kim
President of the World Bank
Washington, DC

Dear Mr. Kim!

On behalf of the Government of Ukraine, I would like to take this opportunity to express our warm regards and appreciation to the World Bank and to you personally for your support in advancing our most critical development objectives. Our excellent partnership has helped to move forward a set of historic reforms supported by the proposed Economic Growth and Fiscally Sustainable Services Policy Based Guarantee (PBG). We believe that these historic reforms are critical in Ukraine's efforts to bolster prospects for economic growth, improve the effectiveness of social services, and strengthen fiscal sustainability in a challenging economic context.

Ukraine has implemented far-reaching reforms since unprecedented shocks hit the economy in 2014-2015. These reforms have helped stabilize the economy and the financial sector, reduce large macroeconomic imbalances, and cushion the impact of the shocks on the population. As a result, after a cumulative 16 percent contraction in 2014-2015, the economy grew by 2.3 percent in 2016, 2.5 percent in 2017, and 3.5 percent in the first half of 2018. The general government deficit was reduced from 10 percent of GDP in 2014 to 2.3 percent of GDP in 2015-2017. The monetary policy commitment of the National Bank of Ukraine (NBU) to medium-term price stability has helped to reduce inflation from a peak of 61 percent in April 2015 to 9 percent in September 2018. The current account deficit has narrowed from 9.2 percent of GDP in 2013 to 2.1 percent of GDP in 2017 and Ukraine's international reserves have strengthened from \$13 billion at end-2015 to \$17.2 billion (equal to 3 months of imports) in August 2018. The banking sector has been stabilized by strengthening supervision and putting in place a framework to recapitalize and resolve banks.

At the same time, we are fully aware that we face major development challenges and we are fully committed to addressing these challenges, in order to deliver better living standards for the Ukrainian people. Specifically, we are fully committed to strengthening the foundations for stronger and sustainable economic growth. We believe that accelerating economic growth is central to reducing poverty and household vulnerability which remain elevated since the economic crisis of 2014-2015. Second, we are fully committed to safeguarding macroeconomic and fiscal sustainability and mobilizing adequate resources to meet our financing needs. Third, we are fully committed to strengthening the effectiveness of health, education, pensions, and social benefits in a fiscally affordable manner.

Our macroeconomic policy framework is strong and underpinned by our commitment to reforms to support the following key objectives: (i) achieving economic growth of 3 percent in 2019 and 4 percent in 2020 by bolstering investor confidence; (ii) meeting the fiscal deficit target of 2.3 percent of GDP in 2019 to gradually reduce public debt; (iii) maintaining a flexible exchange rate and boosting exports and FDI to support external sustainability; and (iv) facilitating credit growth to the private

sector by strengthening the governance of state owned banks and reducing nonperforming loans. Our macroeconomic framework is supported by this proposed PBG, by the Euro 1 billion European Union Macro-Financial Assistance (MFA), and by the expected 14 month, \$3.9 billion IMF Standby Arrangement (SBA). On October 19, 2018, we reached staff level agreement on the new IMF SBA, and we are fully committed to completing all prior actions to secure approval of the IMF SBA program in December 2018.

The Government of Ukraine is also committed to persevering with its ambitious structural reform agenda. The strategic directions of the Government's reform agenda are articulated in the Medium-Term Action Plan for 2017-2020 approved by the Cabinet of Ministers in April 2017, which sets a goal of "increasing standards of living and quality of life via sustainable economic development". We are committed to actions which are economically sound, technically feasible, and are designed to trigger lasting positive impact. Budget support from international financial institutions is very important to further reinforce our capacity to effectively deliver on this commitment while at the same time sustaining the momentum of institutional and systemic reforms that are underway in Ukraine.

Support from the World Bank is critical to the success of our ambitious reform agenda. The proposed Economic Growth and Fiscally Sustainable Services Policy-Based Guarantee (PBG) is designed to support key elements of our policy reform agenda to build the foundations for stronger economic growth and to safeguard macroeconomic and fiscal sustainability. The key policy reforms supported by the PBG are organized under the following two pillars representing key development objectives: (i) strengthening factor markets and institutions; and (ii) promoting fiscally sustainable and effective services.

Strengthening factor markets and institutions

The reforms under this pillar in the financial sector, agricultural land markets, and anticorruption are intended to tackle major bottlenecks to investment and growth. We are committed to strengthening the governance of state-owned banks and putting in place measures to enable resolution of non-performing loans (NPLs) to enable a gradual resumption of lending to the private sector. We are also committed to strengthening the transparency and security of land rights to create the conditions to establish agricultural land markets and improve incentives to invest and improve productivity. We are also committed to deeper anticorruption reforms to address investor demands to create a level playing field and attract foreign investment. These reforms are expected, over time, to strengthen investor confidence and help Ukraine shift from a reliance on commodity exports toward higher value-added exports integrated with European and international production chains. In order to address these objectives, we have completed the following specific and ambitious reform actions:

We have enacted Law No. 2491-VIII "On Amendments to Certain Legislative Acts of Ukraine on Improving the Functioning of the Financial Sector in Ukraine" dated July 5, 2018 to establish independent supervisory boards and strengthen risk management at State Owned Banks (SOBs) and banks, in which government has over 75 percent share; and we have adopted a strategy for the development of SOBs and banks, in which government has over 75 percent share, that establishes a roadmap for gradual divestiture. We are committed to implementing this reform in full in 2019 to achieve the result of raising the number of SOB and banks, in which government has over 75 percent

share supervisory boards with at least two-thirds of independent board members from 1 in 2016 to 4 in 2019.

We have enacted Law No. 2245-VIII “On Amendments to the Tax Code of Ukraine and Certain Legislative Acts of Ukraine on Balancing Budget Revenues in 2018” dated December 7, 2017 to remove the 25 percent ceiling for provisioning expenses and issued orders on the tax treatment of transactions involving nonperforming loans; and we have enacted Law No. 2478-VIII “On Amending Certain Legislative Acts of Ukraine Regarding Resumption of Lending” dated July 3, 2019 to increase creditors’ rights.

We have strengthened the transparency of agriculture land records by: (i) integrating the cadaster and the registry data; (ii) approving Cabinet Decision No. 31 dated August 22, 2018 to commit to the registration of all state agricultural land by December 2020; and (iii) establishing a land governance monitoring system including rental and sales prices. We are committed to fully implementing these reform actions, and to achieve the result of increasing the amount of registered state land from 1 million hectares in 2016 to 4 million hectares in 2019.

We have enacted Law No. 2447-VIII “On the High Anti-Corruption Court”, dated June 7, 2018 to establish a specialized High Anti-Corruption Court comprised of independent judges selected in line with the recommendations of the Venice Commission. We are committed to fully supporting implementation of this reform to achieve the result of establishing the HACC and having at least 25 cases under review in 2019.

Promote fiscally sustainable and effective services

The reforms under this pillar, in the areas of pensions, housing utility subsidies, the energy efficiency fund, and health are intended to strengthen the effectiveness of critical public services and social benefits in Ukraine, while addressing major fiscal expenditure pressures from these areas. Specifically, we are committed to enhancing the adequacy and sustainability of old age pension benefits by strengthening incentives to contribute and better linking contributions to benefits. Second, we are committed to improving the targeting and affordability of the Housing Utility Subsidy (HUS) program. Third, we are committed to establishing the Energy Efficiency Fund (EEF). Fourth, we are committed to transforming the financing of health care. In order to address these objectives, we have completed the following specific and ambitious reform actions:

We have enacted Law No. 2148-VIII “On Amendments to Certain Legislative Acts of Ukraine on Increase of Pensions” dated October 3, 2017 to improve fiscal sustainability, adequacy of old age benefits, and incentives to contribute by providing incentives to retire later in exchange for higher benefits and preserving the value of benefits over time through systematic indexation. We are committed to implementing this reform with a view toward achieving the result of raising the average old age pension replacement rate from 27 percent in 2016 to 30 percent in 2019 and keeping pension expenditures stable at about 10.5 percent of GDP from 2016 to 2019.

We have improved the Housing Utility Subsidy (HUS) program by: (i) revising social norms and parameters of the formula and introducing additional means-testing mechanisms; and (ii) monetizing the HUS settlement at the level of gas and heating utilities, as evidenced by Cabinet Resolution No. 329 dated April 27, 2018 and Cabinet Resolution No. 951 dated November 8, 2017.

We are committed to implementing this reform with a view to raising the share of HUS going to the bottom 40 percent of the population from 46 percent in 2016 to 50 percent in 2019.

We have adopted the charter of the Energy Efficiency Fund (EEF), including procedures for using budget funds for the operation of the EEF, as evidenced by Cabinet Resolutions No. 1099 and No. 1102 dated December 20, 2017. We are committed to implementing this reform, with a view toward the EEF becoming operational and initiating the provision of resources for building retrofits in 2019.

We have enacted Law No. 2168-VIII “On Public Financial Guarantees of Health Care for the Population” dated October 19, 2017 to transform the financing of health care by: (i) shifting from in-patient curative to preventive health care and from input-based to output-based financing; and (ii) putting in place a new transparent health benefit package. We are committed to implementing this reform with a view toward raising the share of health spending on primary care from 12 percent in 2016 to 15 percent by 2019.

I wish to take this opportunity to assure you of our strong commitment to the principles of accountability and transparency in the context of public finance management and donor coordination. In recent years, we have successfully implemented reforms aimed at improving multi-year budgeting, revamping intergovernmental transfers, and strengthening public procurement and public investment management systems. We remain strongly committed to applying these principles of full accountability and transparency, including in relation to all donor support.

We have worked closely and productively with our World Bank colleagues in designing the reform program supported by the PBG and we are committed to working closely to monitor implementing of this reform program. In the year ahead, we are committed to maintaining the reform momentum, while ensuring both the quality and the intended impact of these reforms.

Sincerely,

Volodymyr Hroysman
Prime Minister of Ukraine

ANNEX IV. IMF RELATIONS ANNEX

The IMF Assessment Letter dated November 21, 2018 is appended below. The presentation of the SBA program to the IMF Board is expected in December.

Ukraine—Assessment Letter for the World Bank November 21, 2018

1. With strong support from the international community—including an IMF-supported arrangement under the 2015 Extended Fund Facility (EFF)—Ukraine has been able to make considerable progress in stabilizing the economy since the deep economic crisis of 2014-15, by beginning to address key macroeconomic imbalances and advancing structural reforms. Notably, a drastic fiscal consolidation and the adoption of a flexible exchange rate regime have led to a sharp reduction in Ukraine’s twin deficits. The overall fiscal deficit—including the energy sector’s quasi-fiscal deficit—which had swelled to 10 percent of GDP in 2014, declined to just above 2 percent of GDP last year, supported by prudent fiscal policies and substantial increases in energy tariffs in 2015 and 2016. Similarly, the current account deficit fell sharply from over 9 percent of GDP in 2013 to 2 percent of GDP last year. International reserves tripled and stood at US\$18 billion by mid-November 2018.

2. In addition, some important reforms were advanced during this period. The NBU’s independence and governance were strengthened significantly, the rehabilitation of the banking system was advanced, pension reforms were enacted, and progress was made in setting up new, independent anticorruption institutions. However, after an initial spurt, the reform momentum had slowed more recently, and some key reforms remain incomplete, leaving an ineffective tax and customs administration, a difficult business environment, and a largely inefficient state-owned enterprise sector. The gas and land markets remain largely closed to competition.

3. Although the economic recovery is expected to continue, these challenges weigh on the outlook. Growth reached 2½ percent in 2017 and is expected to reach 3½ percent this year, on the back of strong domestic demand. In the absence of deeper reforms, however, growth is expected to remain constrained to about 3 percent annually, below the growth rates expected by most CESEE countries. An acceleration in reforms would be necessary to strengthen the recovery and for Ukraine to catch up to the income level seen in its regional peers.

4. The Ukrainian authorities have requested a new 14-month Stand-By Arrangement (SBA) with access of SDR 2.8 billion (equivalent to US\$3.9 billion), to provide an anchor for their economic policies during 2019—an electoral year—and against an unsettled external environment. IMF staff and the Ukrainian authorities reached agreement on economic policies for the new SBA in October.

5. The new SBA will build on progress made under the EFF arrangement in reducing macro-economic vulnerabilities. It will focus particularly on preserving macro-economic stability.

Specifically, policies will aim at: (i) continuing the ongoing fiscal consolidation to keep public debt on a downward path; (ii) further reducing inflation to within the central bank's 5 ± 1 percent target range, while maintaining a flexible exchange rate regime; (iii) strengthening the banking system, promoting asset recovery, and reviving bank lending; and (iv) advancing a limited set of structural reforms, particularly to improve energy sector finances, revenue administration, and governance.

6. Based on these policies, public debt is expected to decline further to more sustainable levels. On the back of strong fiscal discipline and a more stable economic environment, public debt is set to decline from its peak of 85 percent of GDP in 2014 to below 70 percent by the end of 2018 and is projected to decline further to 64 percent by end-2019. While the large debt service payments continue to be a source of vulnerability, the full implementation of the program will help unlock official and private financing. Recently, Ukraine raised US\$2 billion in the capital markets, despite the elevated volatility in financial markets.

7. With a policy mix of appropriately tight fiscal and monetary policies and with prospective financing, including from other IFIs and capital markets, the proposed level of access would be adequate to help Ukraine meet its sizable financing needs, while maintaining international reserves at a level equivalent to three months of imports. The EU has approved a new Macro Financial Assistance program (€1 billion), and a new World Bank Policy-Based Guarantee of US\$1 billion currently under consideration would support reforms and strong policy implementation.

8. The IMF staff level agreement is still subject to approval by the IMF Executive Board. Board consideration is expected later in the year, once parliamentary approval of a government budget for 2019 consistent with IMF staff recommendations has been secured and household gas and heating tariffs have been raised to reflect market developments, while continuing to protect low-income households. Preparations for both actions are well under way. Downside risks to the new program are large including the risk of policy slippages, as the pressure for populist policies could rise ahead of the elections. The conflict in the eastern part of the country, although fighting has eased, also remains a key vulnerability. The authorities' steadfast and effective implementation will be critical for the program to fully achieve its objectives. Deeper structural reforms would need to resume after the election period if Ukraine is to achieve the stronger growth it needs to catch up with its peers.

IMF PRESS RELEASE NO. 18/392

IMF and Ukrainian Authorities Reach Staff Level Agreement on a New Stand-By Arrangement
October 19, 2018

The International Monetary Fund (IMF) staff and the Ukrainian authorities have reached agreement on economic policies for a new 14-month Stand-By Arrangement (SBA). The new SBA will replace the arrangement under the Extended Fund Facility (EFF), approved in March 2015 (see Press Release No 15/107) and set to expire in March 2019.

The new SBA, with a requested access of SDR 2.8 billion (equivalent to US\$3.9 billion), will provide an anchor for the authorities' economic policies during 2019. Building on progress made under the EFF arrangement in reducing macro-economic vulnerabilities, it will focus in particular on continuing with fiscal consolidation and reducing inflation, as well as reforms to strengthen tax administration, the financial sector and the energy sector.

The agreement reached today reflects the IMF's commitment to continue to help Ukraine achieve stronger, sustainable, and inclusive economic growth. The new program has been developed in close coordination with the World Bank and the European Union, who have parallel operations to support Ukraine. The authorities' steadfast and effective implementation will be critical for the program to achieve its objectives.

The agreement is subject to IMF management approval and approval by the IMF Executive Board. Board consideration is expected later in the year following parliamentary approval of a government budget for 2019 consistent with IMF staff recommendations and an increase in household gas and heating tariffs to reflect market developments while continuing to protect low-income households.

ANNEX IV. ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior actions	Significant positive or negative environmental effects (yes/no/to be determined)	Significant poverty, social, or distributional effects positive or negative (yes/no/to be determined)
Pillar 1: Strengthen factor markets and institutions		
Prior action 1 SOB	No	No
Prior action 2 NPLs	No	No
Prior action 3 Land markets	Yes, positive	Yes, positive
Prior action 4 A/C Court	No	No
Pillar 2: Promote fiscally sustainable and effective services		
Prior action 5 Pensions	No	Yes, positive
Prior action 6 HUS	Yes, positive	Yes, positive
Prior action 7 EEF	Yes, positive	Yes, positive
Prior action 8 Health	No	Yes, likely positive (tbc)